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# **AN ALTERNATIVE APPROACH TO RURAL FINANCIAL INTERMEDIATION:**

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## **The Philippine Experience**

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Dear Colleague:

During its twenty-one year history, Chemonics International, a professional services firm working exclusively with developing countries, has published occasional papers of interest to policy makers, professionals, and field practitioners. This year's occasional paper focuses on current approaches to rural financial institutional development. Our authors, Meliza Abgabin and Jorge Daly, argue that a holistic or systems approach to rural financial intermediation is essential if viable financial institutions are to emerge and prosper in the thousands of presently unserved or under-served rural communities and secondary and tertiary cities throughout the world.

In addition, they argue that a for-profit, locally owned and managed small scale business model offers the most efficient institutional vehicle for the delivery of affordable and sustainable financial services at the community or municipal level. Forty-four years of rural banking experience in the Philippines provides the empirical foundation to support the thesis that Drs. Abgabin and Daly advance.

We believe the power of the report's message flows from the convincing fusion of these two fundamental principles that together form a systematic strategy for the development of rural financial markets. We hope you that you enjoy and find useful *An Alternative Approach to Rural Financial Intermediation: The Philippine Experience*.

Sincerely,

Thurston F. Teele  
President  
Chemonics Inc.

## ACRONYMS

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ACPC	Agricultural Credit Policy Council
CRB	Cooperative Rural Bank
CFIEP	Countryside Financial Institutions Enhancement Program
DBP	Development Bank of the Philippines
DCB	Davao Cooperative Bank
DOSRI	Directors, officers, stockholders and related interest
HYV	High yielding variety
KB	Commercial bank
LBP	Land Bank of the Philippines
LO	Loans outstanding
M99	Masagana 99
NBFI	Non-bank financial institutions
NCR	National Capital Region
PDB	Private development bank
PKB	Private commercial bank
PNB	Philippine National Bank
RB	Rural bank
RBAP	Rural Bankers Association of the Philippines
SBL	Single borrower limit
SGB	Specialized government bank
SSLA	Stock Savings and Loans Association
SWS	Social Weather Stations
TB	Thrift bank
TBAC	Technical Board for Agricultural Credit
TC	Transaction costs

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## INTRODUCTION

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The economic development of low-income countries is hampered by an inability to bring adequate financial services to vast numbers of rural microentrepreneurs in a timely fashion and at reasonable cost. This failure reinforces market segmentation, prolongs economic inequality, precludes marginalized rural producers from taking advantage of opportunities created by economic reform, and limits the expansion of nationwide financial markets.

To this day, despite the efforts of governments, multilateral development banks, and development practitioners in general, an effective solution to this problem is not in sight. Rural financial markets remain underdeveloped, largely because of the legacy of glaring failures in government-led programs. The record shows that such programs, riddled by large and politically condoned loan defaults, were not sustainable and in fact worsened income distribution, because they were coopted by large rural producers who benefited from subsidized loan rates. Furthermore, they were carried out under a policy framework that was generally unfriendly to the development of finance. These programs left the vast majority of rural entrepreneurs with only the empty promise of access to credit or the services of informal lenders.

After much prodding from the international donor community, many low-income countries have launched far-reaching reforms of their financial markets, including liberalization of interest rates, lowering of reserve requirements, privatization or liquidation of hopelessly decapitalized state banks, and reform of bank legislation—all clear pre-conditions for the development of rural financial markets. The multilateral donors have also taken steps to ensure that policy makers of low-income countries are exposed to the positive lessons offered by some Asian countries, most notably Indonesia and Thailand. These two countries have demonstrated that it is possible for financial entities to expand their services to marginalized rural clienteles. Indonesia's Bank Rakyat Indonesia (BRI) and Thailand's Bank for Agriculture and Agriculture Cooperatives (BAAC) are two shining examples. These state-owned entities have identified small rural households and producers as their market niche, adapted their financial technologies to the rural market demand profile, developed suitable financial instruments, and, most notably in the case of BRI, followed pricing policies that favor self-sustainability.

While these measures are steps in the right direction, neither financial policy reform nor maximum exposure to the financial technologies and managerial strategies of BRI and BAAC can guarantee countries success in developing their rural financial markets. Financial market reform, especially in countries that endured long periods of "financial repression," often falls far short of significantly expanding the supply of financial services to rural microentrepreneurs. In this context, large, urban-based commercial banks cannot possibly shoulder the task of providing financial services to rural entrepreneurs. They lack information on the clientele and do not operate with appropriate financial technologies. Recognizing this impediment, multilateral donors have devised programs to encourage commercial banks to "downscale" their operations in search of profitable opportunities offered by a lower-income clientele. At best, however, this approach takes time to implement and requires a highly competitive banking sector that forces banks to seek new market niches. Even then, commercial banks must go through the process of adapting their approach to microentrepreneurs. In addition, in countries riddled by severe financial dualism, commercial banks will first exhaust options in the urban consumer market or in international operations before attempting a serious downscaling strategy.

Another strategy has been to upgrade the capabilities of nongovernmental organizations to cater to a marginalized rural clientele. In principle, these entities may be transformed into small banks, ridding themselves of their traditional social orientation to pursue profit goals. Unfortunately, there is little reason to expect that the vast majority of these organizations—which have proliferated in low-income countries in response to the failure of credit unions and state-owned banks—can engineer such a successful transformation. In several countries bank legislation must be amended to make a transformation possible. Even so, upgrading is a daunting process, especially in entities staffed by people who adhere more to social goals than to cold banking logic. A complete overhaul is necessary, an undertaking that is extremely costly and almost invariably relies on donor support.

## Purpose and Significance of this Study

The impact of development assistance programs that promote downscaling of commercial banks and upgrading of NGOs is uncertain and at best limited, because success is likely to be limited only to some “pilot projects” whose chances for wide dissemination are suspect. An alternative approach to rural finance is proposed in this study based on the strategy that the Philippines initiated in 1952. Unlike current downscaling and upgrading strategies, the Philippine approach to rural finance emphasizes the design of special legislation to provide incentives for private investment in as many rural banks as possible. It is a systemic approach, not in the least because the newly established units, like any other commercial bank, must adhere to prudential norms and be subject to supervision. The Philippine experience demonstrates significant outreach and appropriate financial technologies, but, unlike the large, state-owned BRI and BAAC, it is grounded in the operation of hundreds of small, independent, privately owned rural banks tailored to the specific market profile of rural areas. After several years in which the survival of most banks hung critically in the balance because of a series of ill-advised policy interventions discussed in the body of this study, the system has shown signs of vitality and growth since 1992.

The purpose of this study is to demonstrate that the Philippine approach to rural finance improves on the strategies currently in vogue and thus offers a better chance of solving the problem of underdeveloped rural financial markets. The approach is little known outside the Philippines and is generally dismissed by development practitioners who associate it with the near collapse of the system in the 1980s and the generous transfer of resources needed to keep the system afloat. Unfortunately, this association misses the larger picture: the principles and institutional components of the Philippine approach are sound. The misguided policies that almost obliterated the Philippine rural banking system can be dispensed with. But the principles provide the basis for solving the problem of rural finance and mitigating the effects of severe market segmentation. As this study will hopefully demonstrate, the Philippine experience is rich and offers valuable lessons for policy makers in other countries.

## Methodology

Demonstrating that the Philippine approach to rural finance constitutes an interesting alternative to the strategies currently in vogue requires an assessment of the rural banking system’s outreach and financial performance. Its outreach is impressive: the rural banking system has a presence in 75 percent of all secondary cities and towns in the country, bringing loan and deposit services to predominantly poor households and microentrepreneurs. To assess financial performance, the study has used data provided by the Central Bank as an indication of how the system has evolved, not as a precise measurement of assets, net worth, and profitability. The methodology, consequently, embraces a healthy skepticism of government data, justified by the fact that the Central Bank provided only time series data of consolidated balance sheets and statements of revenues and

expenses. Unfortunately, this opens the possibility of undetected bias, because excellent overall financial performance, as reported by consolidated statements, may mirror the disproportionate influence of a handful of strong banks and not the majority of units in the system. Furthermore, although the consolidated statements do show the decline of the system in the 1980s, the extent of losses may have been unreported.

This methodological constraint has been compensated by the insights gained from numerous observational visits and field interviews conducted in the course of our investigation. These field contacts, combined with direct assessments of the financial performance of selected units and the fact that official data since 1991 seems to be more reliable, has led the authors to the conclusion that the rural banking system of the Philippines has recovered. Moreover, the system is poised to grow dynamically in the years ahead if the policy environment remains friendly and units continue to mobilize deposits aggressively and enhance their managerial capabilities, both of which are critical to bringing a significant number of rural borrowers and savers into the formal financial sector.

The study is organized in three sections. Section I establishes the context of rural microfinance. It offers an overview of the problems as defined by the “paradigm of rural finance” and discusses strategies currently applied to solve the “paradox of rural finance.” The section argues that such strategies, while constituting remarkable improvements over the flawed government-driven programs of the past, fall short of providing an effective solution to the problems of rural finance. Section II introduces a strategy pursued by the Philippines as a more effective alternative. It provides an overall description of the system, including the policy setting at the time of its inception, the system’s near destruction and rehabilitation in the 1980s, its present organizational design, and, last but not least, an approximation of its financial performance. Section III brings more than 40 years of Philippine experience in rural finance into perspective, pinpointing policy instruments that fostered rural finance and those that were clearly misguided and ineffective. The section also summarizes the most important lessons for other countries. It strikes an optimistic note on the system’s present evolution and its favorable impact on rural populations as well as on national financial markets.



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## SECTION I

### RURAL MICROFINANCE: IMPORTANCE, PROBLEMS, AND STRATEGIES

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#### A. The Importance of Rural Microfinance

Providing financial services to rural populations is important for at least three reasons. First, it has a positive impact on their economic welfare. Households and small entrepreneurs in rural areas cannot possibly sustain rising incomes without access to lending and deposit facilities at reasonable cost. Rural savers benefit from access to deposit facilities and instruments with above-inflation yields that boost their wealth and make possible the financing of additional expenditures. Rural borrowers benefit from access to credit for financing consumption or investment. In both applications, consumption and investment, credit plays a crucial function. For example, when expected income is interrupted due to economic downturns and/or unforeseen natural calamities, credit enables rural households and entrepreneurs to avoid the sale of assets, otherwise necessary to maintain the same level and pattern of consumption. As regards investment, access to credit enables firms to finance expanded levels of production and sales.

Second, the development of rural finance brings tangible benefits to the national economy. If rural financial markets function properly, the overall result is an improvement in the allocation of resources and higher growth of the rural economy. This sets the stage for a more dynamic integration of urban and rural markets. When linkages between rural and urban financial markets are strong, financial markets are homogeneous nationwide, and there is no sharp divide between the so-called “formal” and “informal markets,” financial intermediaries are able to reach a large, critical mass of customers and benefit from economies of scale. In increasingly competitive, globalized markets, scale operations are important in contributing to lower financial intermediation costs and, consequently, to lower the cost of capital. It is worth emphasizing that the high cost of capital is a major impediment to the competitiveness of firms in less developed countries.<sup>1</sup>

Unfortunately, over the last 35 years, economic development experts have wrestled with a nagging, central feature of financial markets in less developed countries: small and medium-sized entrepreneurs in both urban and rural areas are largely marginalized from the web of specialized, dynamic, cost-effective, and innovative financial services that characterize a modern economy. This situation reflects a larger problem whereby policies of exclusion and the ensuing socially unacceptable distribution of assets and incomes have characterized patterns of economic growth in these countries. This is an unfortunate fact in regions and countries that embraced industrial protection *à outrance* to foster overall growth, such as Latin America, India, Pakistan, Egypt, and Nigeria, and other African countries that relied on free trade, but only within the narrow limits that bound them to a handful of industrialized countries during the pre-independence years. In either case, the economic development of rural areas was for all practical purposes neglected, and private finance, which naturally gravitates toward activities that hold the promise of higher returns, reflected an urban bias.

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<sup>1</sup>This problem is particularly serious in Latin America, a region which, after relying for several decades on protectionist policies, is now firmly committed to adopting freer trade regimes. (See Daly et al 1995a).



Third, providing rural financial services at reasonable cost is important because it lessens the effects of marginalization and inequality. Rural producers who are denied financial services find it difficult to adopt new technologies, change factor proportions, and enlarge their scale of operations to respond to favorable domestic and international market signals. These difficulties mean missed opportunities to increase economic efficiency and, consequently, they prolong marginalization. Moreover, small rural producers do not benefit from the more attractive credit terms that are normally available to urban borrowers in formal markets. Urban borrowers can obtain loans more cheaply and with longer maturities, enabling them to undertake longer-term investment projects that result in higher returns.

Recent far-reaching changes in the economic policies of many less developed countries pave the way for measures that can sustain the development of rural financial markets. Market-oriented reforms have been introduced in important areas such as trade and finance, and governments, constrained by the increasing independence of central banks and tougher conditions from international lenders, are taking steps to bring public expenditures under control and balance their fiscal accounts. The logical outgrowths of this process are lower inflation and a structure of relative prices friendlier to export and import substitution. According to conventional wisdom, these changes are ultimately bound to raise incomes and stimulate investments in rural areas, where, consequently, higher volumes of financial services will be made available. Financial reforms have been introduced to enhance this cycle by abolishing controls on interest rates, eliminating credit targeting, lowering excessively high reserve requirements and, in some cases, engineering the liquidation of hopelessly decapitalized state-owned development banks.

Although there is consensus that such measures are required to speed up the development of rural financial markets, it is far from clear that they alone will get the job done. In fact, several years of financial liberalization have not demonstrated convincingly that this type of reform plays a pivotal role in “pushing outwards” the frontiers of formal finance. Despite improved economic conditions in rural areas, it is evident in so many countries, especially those riddled by severe market segmentation in the pre-reform years, that private commercial banks still target their operations to a traditional urban clientele or a handful of large rural concerns devoted to the export of profitable crops. Meanwhile, the majority of small and medium-sized rural entrepreneurs have nowhere to go except to traditional moneylenders, input suppliers, marketing agents, and other informal lenders.

Bridging this gap remains a challenge for every development practitioner today. The rest of this section offers an overview of the problems that stifle the development of rural microfinance, and discusses current strategies that governments have adopted to deal with the most pressing issues. These strategies, which espouse a strict commercial approach by financial intermediaries—either by well-established commercial banks that expand operations into lower-income markets or by credit-granting organizations that service the rural poor—are a significant improvement over previous government-led approaches implemented through poorly run state development banks and credit subsidies. Alternatively, however, policy makers can embrace a systemic approach, which we believe is superior to the strategies currently in vogue. This systemic approach borrows extensively from the experience of the Philippine rural banking system.

## **B. Rural Microfinance: The Problem Defined**

Finance and development experts recognize that severe segmentation plagues financial markets in less developed countries. For many this issue is the starting point of inquiry and largely determines the direction of analysis. It also defines the goals of rural microfinance (to close the gap between

formal suppliers of financial services and the informal customers that demand them), and colors the recommendations (how to ensure that informal customers have sustained access to these services).

In addressing the problem of market segmentation, years of research and practice have delineated the contours of what may be called the “ruling paradigm of rural finance.” This is the view that rural financial services are best provided through a market-driven approach based on concepts of private ownership and open competition, rather than a government-driven approach based on state banking and subsidies. This view recognizes, however, that a successful market-oriented approach depends on solving the “paradox of rural finance,” summarized as follows:

“...providing financial services to marginalized rural clients depends on the solution of the paradox resulting from the fact that those agents with inexpensive access to information and monitoring mechanisms to ensure reasonable repayment rates may not have enough resources or may be too risk averse to provide widespread financial services in their locality, while those who do have the resources and the required attitudes toward risk have no access, at reasonable cost, to the required information and contract enforcement tools.”<sup>2</sup>

This paradox reflects a simple but powerful truth: in the “financially dualistic” economies of less developed countries, resources are overwhelmingly concentrated in the formal or modern sectors, which are located mainly in urban areas. From this perspective, the problem is that the large, urban-based commercial banks, in which the bulk of financial resources are concentrated, are not cognizant of economic conditions and opportunities in rural areas, while entrepreneurs in rural areas who have access to the required information are either too averse to risk or too poor to exploit those opportunities. Consequently, one way to resolve this paradox is to solve the problem of imperfect information that commercial banks face. This problem is particularly poignant in rural areas, because obtaining the required information on rural customers is generally a costly and arduous task that makes it difficult for the lender to assess creditworthiness. When information is poor and unreliable, commercial banks cannot determine which customers are good risks.

Furthermore, in most less developed countries, rural financial markets are generally dominated by high transaction costs, i.e., the costs inherent in “doing business” that are unavoidable for both financial entities and customers. Transaction costs are incurred in two ways, explicitly and implicitly.

Explicit costs are administrative—the costs of personnel, office space, travel, training, maintenance, bad debts, and loan supervision and monitoring that financial entities normally incur. These costs are high in any commercial bank that relies on lending technologies based on project appraisal and asset valuation. Under these circumstances, it is not uncommon for banks to find that the characteristically small loans to rural microenterprises are not profitable.

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<sup>2</sup>Chaves and Gonzales-Vega (1996)

Implicit transaction costs, on the other hand, are costs embedded in obtaining information, negotiating and enforcing contracts, and supervising and monitoring markets and financial entities. These activities normally require the active engagement of the public sector in most countries and are critically important for the smooth functioning of financial markets. The critical element lies in the quality of these “public goods,” in terms of how efficiently and reliably the public sector provides these services. They do not constitute direct operating expenses for financial entities and, therefore, cannot be measured. Yet, these costs largely determine the level of development of financial markets. They are not relevant when markets are underpinned by adequate, high-quality institutions, i.e., by clear, stable, and predictable “rules of the game” that define the property rights in acts of exchange and enforce private contracts at reasonable cost. This, in fact, is the *sine-qua-non* condition for the efficient operation of financial markets, since low-cost trust-building mechanisms, undoubtedly the most critical factor of finance, can be established only with the existence of adequate institutions.<sup>3</sup>

Unfortunately, in most less developed countries, rural markets are seriously constrained by weak institutions. Information-sharing networks, mechanisms for enforcing credit contracts, and adequate systems for supervising financial entities are poorly developed. As a consequence, financial markets are pervaded with weaknesses that largely explain why rural customers, especially small and medium-sized entrepreneurs, are excluded by private commercial banks as potential borrowers. For example, why would private commercial banks be willing to offer loans to borrowers whose collateral—when they have it—cannot be foreclosed rapidly and at reasonable cost? Therefore, within the context of inadequate institutions in the countryside, much cannot be expected of commercial banks, as long as they refrain from launching efforts to devise other trust-building mechanisms.<sup>4</sup>

It is the inability to solve these problems that sets the stage for the emergence of informal financial intermediaries. Shunned by private commercial banks and handicapped by undeveloped institutions, small and medium-sized rural entrepreneurs are doomed to be served mainly by such agents. Informal financial intermediaries are usually endowed with intimate knowledge of local conditions and customers but are unable, at the same time, to provide a lasting solution to the problems of finance in rural areas for three important reasons. First, they are on their own to establish

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<sup>3</sup>This argument is developed by North (1992).

<sup>4</sup>One such mechanism that has had some success is group lending. It facilitates the process of obtaining information, screening applicants, and approving loans. More important, it significantly lowers the risk of loan default. But the fact that part or all of these costs are passed on to borrowers—and that setting up and managing groups has inherent difficulties—make group lending clearly an inferior alternative to individual loans.

norms for validating financial transactions and their own forms of enforcement.<sup>5</sup> Second, informal financial intermediaries do not provide for safe, convenient, and sustained savings mobilization, perhaps the most critical ingredient for the vitality of rural financial markets. Third, because this form of financial intermediation is grounded in personalistic relationships, its potential for expansion is definitely limited.

In the end, the presence of high transaction costs bodes ill for both the rural and the national economy. It mirrors the acute segmentation of markets and helps perpetuate pronounced economic dualism, which smothers the nationwide development of finance. Vast numbers of rural entrepreneurs, precluded in practice from accessing the high-productivity activities that are normally offered in the more narrow, formal, “modern” economy, where strong institutions generally prevail, are left instead to contend with the limitations of the informal economy. A peculiar economic landscape ultimately emerges where many different networks with intensive financial transactions generate few exchanges among themselves because each network is based on personal contact. And this contrasts, most unfortunately, with the numerous, unlimited financial transactions that can be carried out in a large, anonymous market that ultimately gives way to larger economies of scale and lower costs of financial intermediation.

### C. The Responsibility of Governments

If the problem of rural microfinance is not properly addressed, the inequality, exclusion, high entry barriers, and economic stagnation that shape the existence of large numbers of the rural population will be perpetuated. It is therefore urgent to launch an assault on high transactions costs—both implicit and explicit—that permeate rural financial markets. In this regard, governments have a crucial role to play.

There is widespread consensus that governments need to be actively engaged in the steady upgrading of the quality of public services that underpin financial transactions in rural financial markets: enforcing property rights, improving legal systems, developing information-sharing networks and, most important, establishing public trust regarding the liquidity of the financial system, the sanctity of credit contracts, and the safety of deposits. Unfortunately, these efforts will have an impact only in the long run. It is not realistic to assume that the problems associated with the high implicit transaction costs faced by rural entrepreneurs will disappear soon, either by the stroke of a pen or by sound public programs.

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<sup>5</sup>This is true not only for the providers of financial services, but also for the customers who demand them, especially regarding the safety of deposits and prompt return of collateral pledged at the time of loan approval, but due immediately after the loan is paid back.

To policy makers also falls the task of ensuring that private financial activities are conducted in the presence of appropriate incentives and in an economic environment conducive to competition. These basic conditions set the stage for the emergence of financial entities that cater their operations to the particular demand profile of rural microentrepreneurs. The cornerstone of appropriate incentives—price reform—enables financial entities to attain economic viability and maintain the real value of their loan portfolios and capital by charging loan rates that cover operating costs (including loan reserves), cost of funds, and inflation. Moreover, when financial entities operate in an environment where loan and savings are determined competitively, they will have no recourse but to reduce their explicit (administrative) transactions costs, a *sine-qua-non* condition for their long-term survival, which also ensures tangible benefits for rural microentrepreneurs.<sup>6</sup> Quite simply, to survive market competition, financial entities must abide by the general principle that the costs of lending should be commensurate to the size of the loan. For microenterprise loans this translates into very low administrative costs as well as simplified and streamlined procedures for loan application, approval, disbursement, and collection.

Beyond the urgency of implementing these measures, is it advisable for low-income countries to allow for more government activism in developing rural microfinance? At present, the ruling paradigm of rural finance provides no clear-cut answer. Recent trends suggest, however, that the hands off, *laissez-faire* approach to rural finance that was previously espoused so vehemently, probably as an reaction to the glaring inefficiencies that characterized the government-led approach in the 1960s and 1970s, is gradually giving way to the healthy recognition that some conditions do warrant government intervention, and that choosing appropriate policy instruments can ensure that social benefits outweigh the costs of intervention.

This *aggiornamento* is perhaps explained by the sober realization that there is no guarantee that the far-reaching market-oriented financial reforms that many countries have adopted will bolster rural microfinance on the one hand and bridge the gaps between the modern, mostly urban formal markets and the largely primitive, informal markets on the other. Yet, in sharp contrast to the clear and widely accepted policy guidelines that steer macroeconomic stabilization processes, experts in financial markets are still trying to formulate an unambiguous set of principles, policy instruments, and institutional arrangements to solve the aforementioned problems. As will be demonstrated below, these efforts, in essence “trial balloons” to distinguish what works from what does not, have resulted in the dissemination of a few isolated success stories that have little in common with one another and whose chances for replication in other settings is suspect.

#### D. Development of Rural Microfinance: Successful Experiences and Current Strategies

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<sup>6</sup>This is not true when interest rates are freed under monopolistic or oligopolistic conditions. Under such circumstances, financial entities are not restrained and can thus raise loan rates to cover operating costs. This penalizes economic efficiency because financial entities can earn huge rents that are derived from the abnormally high spreads they maintain between the cost of funds and loan rates. In addition, high interest rates discourage badly needed investments in the countryside. All this impinges on the welfare of the marginalized rural population.

A successful strategy to expand the provision of financial services to rural entrepreneurs must meet two basic criteria: outreach and sustainability. The two are closely interrelated. The ability to meet the demand for financial services for as many rural microentrepreneurs as possible (outreach) is inseparable from the capabilities of financial intermediaries to provide services efficiently over time (sustainability).

Reducing explicit transaction costs bears significantly on outreach, whereas mobilizing savings, which lessens dependency on outside funds, impacts positively on sustainability. In this regard, the ruling paradigm of rural finance strongly recommends that public policy be directed toward finding ways to propel these actions.

#### D1. Successful Experiences

The list of successful experiences is long and spans several countries and continents. A partial account includes the following:

- Bank Rakyat Indonesia (BRI), the oldest and one of the largest government-owned banks in the country. Also in Indonesia, Bank Kredit Kecamatan (BKK) and Bank Kredit Desa (BKD), operated by provincial governments, reach a smaller clientele than that served by BRI.<sup>7</sup>
- The Grameen Bank in Bangladesh, widely considered a pioneer in rural microfinance. It caters its operations primarily to poor rural women.
- Thailand's Bank for Agriculture and Agricultural Cooperatives (BAAC), a government-owned bank established in 1966 whose policies and operations are controlled by the Ministry of Finance.<sup>8</sup>
- Chile's Banco de Desarrollo and Ecuador's Finagro, two privately owned financial entities that provide financial services to small farmers.

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<sup>7</sup>For a penetrating study of Indonesia's financial system, see Chaves and González-Vega (1993).

<sup>8</sup>An analysis of the operations of this bank is provided by Yaron (1992).

- Some credit unions that have been restructured successfully.<sup>9</sup>
- Bolivia's PRODEM, a well-run nongovernmental organization (NGO) that recently established its own bank, BancoSol.

These success stories share three important elements. First, they have targeted a low-income clientele. Second, they have developed simple financial instruments and tailored their explicit transaction costs to their client profile. Third, they have adopted a commercial approach to their operations and are thus concerned with generating profits and long-term sustainability.

But most striking is the diversity of the experiences. Indonesia and Thailand have made great strides towards solving the problem of rural microfinance through unrelenting public support for the strengthening of two state banks. The strength of the Grameen Bank stems from its exceptional leadership and high-quality management, but critical support still comes from international donors. International assistance is also an important factor in the case of PRODEM and the restructured credit unions, but their outreach is not nationwide. This limited outreach is even more pronounced in the cases of the two private banks in Chile and Ecuador. The operations of these entities meet only a fraction of rural demand for financial services and, despite the fact that they have been active for several years, their example has not been followed by other private concerns.

Therefore, it is not unreasonable to conclude that all best practices constitute special cases. Furthermore, the entities involved exhibit different organizational designs: success applies equally to state banks and to privately owned financial concerns and nonprofit organizations. This is hardly an ideal scenario in theoretical and policy-oriented undertakings that seek accurate diagnoses of rural finance problems and widely applicable recommendations for their solution. As noted, however, these successes are the foundations of the strategies currently recommended by experts in the field.

## D2. Strategies

Two basic strategies are currently in vogue: downscaling and upgrading existing financial entities.<sup>10</sup>

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<sup>9</sup>One of the most notable examples was in Guatemala and is described in Daly (1994).

<sup>10</sup>The discussion of these two strategies has benefited enormously from Schmidt and Zeiting (1994a).

Downscaling. The downscaling strategy relies on the feasibility of well-established public or private commercially oriented banks to expand operations and provide financial services to small customers in urban and rural areas. The strategy does not refer to the bridging of loans through informal financial intermediaries, such as local traders, input suppliers, and credit-granting nongovernment organizations.<sup>11</sup> It does refer to efforts to reach such clientele directly through specially designed operations.

Bank Rakyat Indonesia (BRI), a state-owned bank, has implemented a downscaling strategy with enormous success for more than a decade. Some of the most important features of this bank are worth highlighting:<sup>12</sup>

- Until the early 1980s, BRI operated mainly as a “faucet” and not as a bank. In other words, it was a vehicle for delivering subsidized credit from the central government to its target groups.
- Goals and operational procedures changed radically in 1984 with the introduction of small-scale banking activities through the Unit Desa network. This network consists of more than 4,000 branches and sub-branches scattered throughout the country, with no more than four employees in each of the sub-branches.
- Each Unit Desa is an independent profit center, yet is appropriately supervised by a BRI branch.
- Each Unit Desa follows a commercial approach to banking: operations are client-tailored, credit is not targeted, and loan and savings rates are set above costs and inflation.
- All these factors account for the impressive results achieved by the end of 1994: arrears are very low; loans, which average US\$673 in size, have grown considerably, mainly to small

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<sup>11</sup>Each of these mechanisms can be conceived as the pooling together of commercial banks with the holders of information on rural customers. But these mechanisms are flawed. Why, for example, would traders and input suppliers, who are not specialized in banking, be willing to engage in financial intermediation? Even if they are, the type of credit that typically results is very limited, because it is linked to market demand for a specific commodity. Consequently, it does not represent a “line of credit” that can be renewed by the same rural borrower for another crop or productive activity. Linking commercial banks with NGOs for on-lending operations is a questionable proposition in countries where these entities are not properly regulated. And because many are poorly run, they are perceived to be high risks by commercial banks.

<sup>12</sup>See Patten and Rosengard (1991) for a thorough analysis of the operations of this bank.



rural customers; savings accounts have grown exponentially, surpassing the volume of loans outstanding by a factor of two. Last but not least, although the bank reported US\$25 million in losses in 1984, it now reports profits.

At present, the ruling paradigm of rural microfinance has all but declared that the Bank Rakyat Indonesia is the model for other countries to follow. It attributes the success of this model to the bank's lending and savings mobilization technologies—not to its ownership arrangement. But other countries may be tempted to replicate the state ownership arrangement as well, especially considering the confidence that the state's implicit deposit insurance instills among the rural population. Thus, efforts have been made to identify the conditions for a successful restructuring of state banks in low-income countries. These conditions include deposit mobilization, capitalization, independence, incentive-compatible governance, safe and diversified portfolio, decentralization, human resource policies, transparency, financial performance, and donor support.<sup>13</sup>

Yet, one questions the real chances of successful state bank restructuring. In most countries, state development banks traditionally have followed “development” practices inimical to market discipline, as revealed by the ill-conceived “welfare approach” to their clientele that ultimately led to their decapitalization. Most are riddled by high rates of non-repayment and confront problems of poor management and political intrusion in lending practices. One could argue that these conditions also characterized the BRI in its pre-restructuring stage. At the same time, one suspects that the two most critical conditions for the successful restructuring of state banks—the capacity to attract and maintain high quality managers and freedom from political interference in the long run—are in short supply in many low-income countries.

Consequently, the responsibility to carry out the downscaling strategy falls on private commercial banks. For private banks to be successful in this endeavor, however, a competitive financial system must exist. Competition is the key factor, the catalyst that ensures that existing or new banks are motivated to adopt innovative techniques for servicing an expanded clientele. Owners and top managers of private commercial banks will not enter the market of rural microentrepreneurs unless they feel compelled to do so, to obtain larger profits or keep their share of an expanding national market. There is no doubt that well-designed and carefully implemented financial policy reforms will advance the process. In particular, policies that level the playing field for foreign and local investors may reduce the rents earned by traditional banks in market segments with the safest and best customers. Entities that lack innovative, forward-looking management and are controlled by economic groups will probably stick to their old ways, fighting to keep their share of formal markets. Meanwhile, other banks, especially those with more aggressive savings mobilization campaigns, or newly established entities that have found their market niche in small customers, may surge ahead.

In spite of the financial reforms they initiated several years ago, Latin America and Asian countries show no fundamental “success stories” of private commercial banks implementing a downscaling strategy. This may be because the process of financial reform in these countries is far from complete. A more plausible explanation lies in the many problems associated with high transaction costs in rural areas. But even allowing for more competitive conditions in financial markets and improvements in the quality of institutions, private commercial banks will not necessarily “change gears,” at least immediately. This unfortunate reality is grounded in the issue of corporate governance: ownership arrangements of private commercial banks in so many low-income countries invariably ensure that the nature, scope, and quality of their products gravitate toward

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<sup>13</sup> An excellent discussion of this issue is found in González-Vega and Graham (1995).

traditional, well-known clienteles. This trend is especially true in countries where economic duality overlaps with extreme social, cultural, and ethnic divisions and where most urban-based formal banks are owned by groups that belong to national elites. Moreover, in pursuing opportunities that arise with financial reform, commercial banks would probably choose to expand into internationally related operations and, to a lesser extent, into urban-based small loans and consumer-credit, but not into services for rural microentrepreneurs.

**Upgrading.** The upgrading strategy, on the other hand, is based on the principle that “the character of owners and managers largely determines who gets the credit.” As such, it presupposes the organizational strengthening of entities that are “closest to the poor,” such as credit unions, credit-granting NGOs, and village banks, but whose principal drawback is that they operate mainly as self-contained units, with weak or nonexistent links to the formal financial system. The key challenge of this strategy is to transform those entities into economically viable, self-sustaining financial entities capable of mobilizing deposits and subject to the same norms and regulations that apply to commercial banks. The task is facilitated by the fact that these entities already have a market niche, because they are fully cognizant of the characteristics and demand profile of their clientele.

On the other hand, this strategy faces monumental challenges, including the two most important: (1) transforming entities that were originally established with a nonprofit orientation into units that must adopt a commercial approach to survive market competition; and (2) meeting the licensing requirements specified by regulators.

Bolivia's BancoSol is often cited as an example of successful upgrading. PRODEM, an NGO, established this bank in 1992 and has accepted equity positions from outside local investors and international donor organizations. So far, available indicators suggest that bank operations are remarkably impressive. For example, from February 1992 to January 1995:

- The number of clients increased from 24,000 to 62,000.
- Outstanding loans rose from US\$4 million to US\$31 million.
- The average loan size increased from US\$331 to US\$532.
- The number of offices rose from 5 to 29, and the number of employees rose from 64 to 305.

BancoSol rediscounts loans with La Paz-based commercial banks and is reportedly posting substantial profits and raising US\$500,000 in certificates of deposit that will be issued in international markets. These are all very important developments, because they signal a lessening of market segmentation on the one hand and increasing confidence from local and international investors on the other. So far, however, the bank has chosen not to go into rural areas. Its niche lies in small households and women-run microenterprises in peripheral areas of urban centers. Furthermore, in stark contrast with BRI, BancoSol's performance with respect to deposit mobilization has been painfully disappointing: the value of its outstanding loans is 10 times greater than that of its deposits. This problem has not been addressed adequately and thus clouds prospects for long-term self-sufficiency.

Because of the apparent success of BancoSol, NGOs have seemingly elbowed out credit unions as the preferred vehicle for the upgrading strategy. In the 1980s, in response to the collapse of many state banks or their withdrawal from rural markets, and the failure of unrestructured credit unions, many credit-granting NGOs were launched in low-income countries. In most cases, they had the

financial patronage and technical assistance of foreign donors. There is no doubt that these entities have played an important role in providing credit to a marginalized clientele, although there are doubts about their real efficiency in terms of productivity, setting interest rates on loans, and covering costs.<sup>14</sup> These inefficiencies, in combination with weak management, poorly developed human resources, and inappropriate lending technologies, are monumental obstacles to their successful transformation into full-fledged banks.<sup>15</sup>

Finally, the issue of corporate governance is also of overriding importance in the upgrading strategy. Unlike the clearly interpreted ownership arrangements enshrined in the bylaws of private commercial banks, entities that are “closer to the poor” may suffer from poorly defined ownership rights. For example, the viability of credit unions as self-sustaining entities is endangered when borrowers exercise permanent control or management is constrained by unclear mandates from the membership. Many NGOs are financially dependent on foreign donors, who may influence the NGO’s operations, such as in targeting credit, in ways that are not conducive to its long-run sustainability. Even if foreign donors refrain from acting in this way, NGOs must contend not only with unclear ownership rights but also, because they were originally created with a “social orientation,” with conflicting management objectives.

#### E. The Need for an Alternative Approach

The ruling paradigm of rural finance has made an outstanding contribution in the field. By offering a careful diagnosis of the complexities inherent in the expansion of financial services to marginalized clienteles, it has successfully challenged the cheap credit policies that underpinned the pervasive, misguided intervention of governments in rural financial markets, and which contributed greatly to higher rates elsewhere in the economy, the neglect of savings, and the worsening of income distribution. As a result, fewer and fewer low-income countries are still wedded to the policies of the past.

The problem is that this diagnosis has yet to produce a consistent set of policies based on principles apt to be applied equally to different countries and settings. It fails to include a vision of how a system of many “success stories” can emerge, and how this system can spearhead the development of financial markets for the benefit of rural microentrepreneurs. A successful undertaking recognizes that markets in rural areas are indeed constrained by failures and imperfections that require immediate intervention. Fortunately, most experts in the field have taken stock of this reality. The challenge, consequently, is to devise a strategy for intervention that can be applied easily and effectively, and that will yield benefits that outweigh its costs.

This is not to suggest that the strategies now in vogue, downscaling and upgrading, are fatally flawed. They represent a significant improvement over the faulty strategies of the past and, if properly implemented, will certainly make a positive contribution towards solving the problem of

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<sup>14</sup>For an empirical study on this issue see Schmidt and Zeitingner (1994b).

<sup>15</sup>A recent empirical study of 30 credit-granting NGOs in Honduras shows that only three have a fair chance of graduating into banks. See Daly and Alvarado (1995).

finance for small entrepreneurs in rural areas. But the shortcomings of these strategies are impossible to ignore. The most serious is that their impact is likely to be limited: the “success stories” will remain “pilot projects” with little chance of replication elsewhere. In other words, these strategies are unlikely to foster the creation of large numbers of sufficiently capitalized concerns and, consequently, no widespread expansion of financial services to the rural poor will take place.

This is because the financial entities that emerge from these strategies are not market-generated. BRI, a state-owned bank, has long operated in a monopolistic setting that has made possible the earning of large rents. Furthermore, behind the success of this Indonesian concern lies a government that commands vast resources.<sup>16</sup> In many other countries, governments are constrained by scarce resources and, unlike the Indonesian government with its tradition of sound banking practices dating back to the 19th century, do not elicit the trust of their populations. On the other hand, downscaling by private commercial banks faces a major constraint: implementing this strategy requires costly investments. Information must be collected about the clientele, new branches must be established, and managers and bank officers must be trained in the new deposit-taking and lending techniques that render microenterprise operations profitable.

If market forces do not compel private commercial banks to downscale, and if chances for a successful restructuring of state development banks *à la BRI* appear slim as in most countries, it behooves other actors concerned with development to take the initiative. The international donor community is well-positioned to do so, having taken a keen interest in both the design and implementation of current strategies. For example, international donors are advocating a useful role for themselves in downscaling strategies by offering seminars to wide audiences on the technologies necessary to provide financial services to small customers. In addition, they can offer resources to selected banks willing to downscale for training loan officers in microfinance techniques, the implementation of computer-based credit expansion and monitoring systems, and assistance in establishing new branches in strategic locations.<sup>17</sup> On the other hand, with respect to upgrading, international donors are firmly convinced that providing technical and financial assistance to credit-granting NGOs, cooperatives, and other entities that exhibit the conditions for an eventual successful transformation into formal banks holds the promise of high returns. Such assistance would be aimed at restructuring the entity, promoting its capitalization, providing intensive training to upgrade

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<sup>16</sup>This does not refer to continuing access to government funds either for recapitalization or for expansion of operations. If anything, the bank is profitable. Yet, two sources of implicit “subsidies” exist: First, before the establishment of the Unit Desas, the government had already established a large number of branches in the countryside that were utilized by the Bimas Program. This was a costly investment in infrastructure that the bank took advantage of in an efficient way. Second, being a state bank, savers feel assured that, should bad times arrive, the government will honor their deposits.

<sup>17</sup>At present, the Inter American Development Bank has launched a program of technical assistance in implementing the “downscaling” strategy in selected commercial banks of Costa Rica and Peru.

financial reporting and information systems, introducing the appropriate savings and credit instruments, and enhancing management capabilities.

Will these donor-led activities exert a positive influence on the development of rural microfinance? The answer is a definite yes. Will they lead to a sustained expansion of financial services for the marginalized rural clientele? Unfortunately, the jury will be out on this question for a long time. The *geist* of these approaches lies in selecting particular entities with the expectation that their successful adaption (downscaling) or transformation (upgrading) will serve as a powerful example for other entities to follow. Unfortunately, however, neither their successful implementation nor replication elsewhere can be taken for granted. First, in the case of downscaling, it is not clear why, in these times of increasing bank specialization in specific market “niches,” banks would follow the lead of a bank that downscaled. Second, as regards upgrading, selecting the entities is not devoid of obstacles: how many credit-granting NGOs around the world are blessed with a board of trustees and management team that possess the strategic vision and skills necessary to transform the entity into an economically viable bank? Third, donors are constrained by scarce resources. Will they be able to secure enough financial resources from their directors and managers to implement a project that is very costly and long term? And since different donors support different NGOs, how feasible is it for them to coordinate actions and pool resources to set up a few full-grown entities that can benefit from a larger scale of operations?

For all these reasons, efforts focused on bridging the gaps between formal and informal financial markets by way of downscaling commercial bank operations and/or upgrading existing credit-granting entities are misdirected. Such undertakings are operationally complicated, costly, and of uncertain return. Furthermore, their implementation in most low-income countries depends on donor support and, even when this materializes, impact is bound to be isolated and limited. In sum, one can conclude that these strategies fall short of providing an adequate solution to the problem of rural microfinance.

Consequently, an alternative approach is urgently needed. The approach presented in this study relies heavily on the experience of the Philippines and demonstrates that it would be far more efficient for governments and international donors to focus their efforts on promoting the creation of new financial entities specialized in providing services to rural microentrepreneurs. It is based on the central premise that countries may have regionally based entrepreneurs and community-based cooperatives with both the wherewithal and the information on local conditions and clients, but which need the appropriate policy setting and institutional support to invest in “banking for the rural poor.” This alternative approach has five basic elements:

- It concentrates on creating the conditions for the emergence of as many rural financial entities as possible, rather than focusing on particular entities with alleged advantages for rural microfinance, such as state banks, credit unions, villages, NGOs, village banks, and so forth.
- It favors locally based private ownership of these rural financial entities.
- It supports the development of a national rural banking system composed of multiple units of privately owned country-based rural banks. The approach encompasses the establishment and strengthening of all the institutional components that accompany the functioning of commercial banks—a legal and accounting framework, prudential regulation and supervision, a rural bank association, and a rural bank training institute.

- Regionally based entrepreneurs and community-based organizations play the catalyst role as investors. The legal and regulatory frameworks, consequently, are tailored not just to the demand profile of the clientele, but to the financial capabilities of these investors and the economic potential of regional markets. This entails, for example, lower capital base requirements, because small rural banks cannot possibly comply with the same capital base requirements as the “behemoths” in urban areas.
- More government activism is necessary. This is realized not only through the enactment of special legislation, but also through selected subsidies, provided these are easy to administer and do not create distortions or lead to the creation of unproductive rents. Institutional technical assistance and training constitute examples of “good” subsidies.

Finally, the advantages of adopting this approach are significant. Embracing it presupposes, first of all, a slight redefinition of the paradox of rural finance. It is no longer that “agents with resources have no access to information (about small rural clients)” but that “agents who have the resources and the required information do not have the appropriate incentives nor the institutional framework to invest in the establishment of rural banks.” A Philippines-like systemic approach to rural finance offers the answer to this redefined paradox because it does provide the missing elements—appropriate incentives and an adequate institutional and policy framework. Furthermore, the returns for society are incalculable. Not only will rural microentrepreneurs find convenient access to formalized banking services. But the approach also spurs the emergence of new banks that have a stake in the economic conditions of the rural economy and the political muscle, through their rural bankers association, to demand vigorous government action for providing or upgrading the quality of public services that underpin the development of rural financial markets.

This approach was implemented in the Philippines beginning in 1952. By the end of 1994, the rural banking system was comprised of 745 family-owned rural banks and 39 cooperative rural banks with 1,274 outlets operating in 75 percent of all secondary cities and towns in the country. On the whole, the system has had a stormy existence, not devoid of devastating crises caused, at times, by well-meaning but ultimately misguided intervention by the government for its own political purposes. Remarkably, however, as will be unveiled in this study, it has survived. Moreover, it is now poised to expand vigorously and is well on its way to becoming an efficient vehicle for bridging the gaps of financial dualism. In fairness, this process has been led by the best units, who have profited from an intimate knowledge of their customers resulting from their geographic and cultural proximity to the rural communities they serve. These units have best understood the advantages of delivering simple financial services at low explicit transaction costs, and which have assigned critical importance to the upgrading of management and personnel skills to ensure the adoption of sound banking techniques. Because of their resilience in the face of adversity and impressive operational efficiency, which are rapidly resulting in expanding assets, loan portfolios, deposits, income, and capital, they are shining examples for other units to follow.

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## SECTION II

### THE PHILIPPINE RURAL BANKING SYSTEM: POLICIES AND PRACTICES

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#### A. General Overview

The Philippine rural banking system is a unique institutional innovation that is anchored in private ownership, autonomy, and independence. After more than four decades of trial and error, the system is characterized today by more dynamism and growth than ever experienced in the past. This phenomenon is taking place under a liberalized policy regime that permits rural banks to be creative and to expand their resources, broaden their services, and improve operational efficiency and profits. The situation is in stark contrast to that of the past, particularly the 1980s, when the survival of the rural banking system hung critically in the balance.

##### A1. Composition of the System

The rural banking system is only one of many types of banks and non-bank financial institutions that comprise the Philippine financial system (Figure 1). Although the system holds only 2.2 percent of the assets of a banking industry largely dominated by commercial banks, by the end of 1994, 784 unit rural banks with 490 branches nationwide made up one-fourth of the banking system's outlets and provided credit access to about half of all Philippine households that borrow from banking institutions.

Three major types of entities, by ownership, compose the rural banking system. Cooperative rural banks (CRBs) owned by cooperative organizations are one type. CRBs are in the minority, numbering 39 units in 1994 and holding 5 percent of the rural banking system's assets. Closed family-owned banks are the second type, and are in the majority. Community banks whose ownership is more widespread among many families or individual investors are the third type. Ownership of rural banks by commercial banks has also become a reality but is very minimal at present.

##### A2. Clientele

Rural banking is but a small percentage of the country's entire banking system in terms of resources. Nonetheless, because of its significant presence in three-fourths of the country's towns and cities and its long tradition of providing lending and deposit-taking services, the rural banking system has a deeper market penetration than the rest of the banking system in rural locales. At the household demand level, the system reaches more borrowing households than do commercial banks. Based on surveys by Social Weather Stations, a private polling organization, of all households borrowing from banking institutions, 45 percent borrow from rural banks.<sup>1</sup>

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<sup>1</sup>Social Weather Stations, June 1995 survey round, Philippines; 1,200 heads of households were asked: "In the past 12 months, has your family received a loan worth at least P1,000 at one time? If yes: Who was the chief creditor for your loans this past 12 months?" Social Weather Stations has tracked household level borrowing since 1986.

Figure 1



Of all formal sources of credit licensed by the country's Central Bank, rural banks are the second most important source after the aggressive lending investors.<sup>2</sup>

In the past rural banks were protected from competition in their areas of franchise. Now they are operating side by side with other types of financial institutions, including lending investors, pawnshops, commercial banks, thrift banks, and credit unions. Moreover, as in other countries characterized by financial dualism, informal agents still play a dominant role in the financial market, and rural banks compete with them to some extent on the credit side. It is estimated that some 69 percent of Philippine households that obtain loans do so from informal creditors.

Rural banks may be the only formal institutions in towns that are still basically agricultural (see Box 1). In such areas, the opportunities for non-farm enterprises may be limited, and the level of poverty higher. In the Philippines, in general, the relative level of poverty is higher in rural than in urban locales. Over the years, however, the rural locale has been shrinking as urbanization and commercialization invade the countryside. Because of a more stable economy in recent years and the continuing liberalization of the macroeconomic landscape, towns near large regional cities and along the corridors of commerce and trade are becoming more economically active and diversified. This trend creates demand for a variety of banking services and presents opportunities for rural banks.

Long before microfinance and microenterprise finance became buzz words in the development literature, rural banks were operating as formal microfinance institutions. Microfinance services are inherent in the institutional and structural character of rural banks. To this day, their deposit instruments are designed to capture savings as small as US\$4 to US\$8, in contrast to the US\$80 to US\$200 minimum acceptable to most commercial banks. On the lending side, rural banks generally cater to a wide variety of clientele composed of small farmers, shopkeepers, market vendors, small traders and businessmen, small urban and rural transportists, wage earners, teachers, women from poor families, and cooperatives. In comparison with other banks, their loans are small, with minimum amounts of US\$40 to \$80. Survey findings also tell us

The Community Rural Bank of M is 21 years old. It is the only bank in a predominantly agricultural town, where most of the farm holdings are small and devoted to rainfed rice culture. Household incomes are thus seasonal. Located away from the center of town, the rural bank was set up with a small capital of P250,000 by farmers and community leaders to help the community. Its inability to reach beyond the borders of the town has kept the bank small and its lending portfolio homogeneous and risky. However, it is presently in the early stage of increasing its capital from new investors, improving its management system and leadership, and diversifying its loans to non-farm activities.

For more than 20 years, the rural bank of St. Tomas was the only bank in an agricultural town of small farmers and banana plantations. Overall, the bank's growth has been sluggish at best. Recently, however, the establishment in 1993 of a branch of a cooperative rural bank ended its monopoly position, and its performance has improved.

<sup>2</sup> Lending investors reach 33 percent of households who borrow from banks and non-bank financial institutions. Lending investors are small credit shops that began to sprout during the 1980s and grew rapidly after ceilings on interest rates were lifted. Lending investors are licensed by the Central Bank, have very small capital requirements, and provide small loans under quick processing procedures.

that 95 percent of households borrowing from rural banks are poor, with only 5 percent belonging to the rich and middle classes. The rural banking system caters to an equal mix of rural and urban-based borrowers. A few large and strong rural banks are able to upgrade their markets and cater to medium-scale businesses, real estate developers, and housing loans. These units are located in more commercialized and urbanized towns near major cities or industrial zones.

### A3. Pioneers and Owners of Rural Banks

The private owners who pioneered rural banks came from a wide variety of backgrounds and professions. They were farmers, retired school teachers, college professors, physicians, dentists, retired government employees, small local businessmen, former money lenders, and members of cooperatives and credit unions. It was not unusual to find the owners running their banks as managers and officers, despite the fact that many had no banking background. Some rural banks were set up by the local political and/or business elite for political purposes or as status symbols.

A few examples will help illustrate the great diversity of rural bank founders and owners. For instance, the Rural Bank of Los Baños was organized in 1960 by a group of college professors and their families in the town of Los Baños, Laguna, as the town's first bank. One of the bank's founders, a retired professor of agriculture, was the bank's first manager, while the wives of the other professors served as officers and board members. Because they were not bankers, they followed extremely conservative policies, and feared giving loans as much as accepting deposits. With the passing of time, the bank's management passed on to second generation family members who modernized its operations and turned it into the biggest and one of the strongest and most modern in the system.

The Rural Bank of Panabo was set up by a physician and his family and friends in the province of Davao. The physician managed the bank for some time, but later passed on the management to his son, an economics graduate with corporate marketing experience. The bank has evolved from rudimentary to modern banking practices and is reaching out to small savers, borrowers, farmers, and small businesses.

Five families established the Rural Bank of Tupi 15 years ago, but the bank is now owned by only one family. Lifting the 20 percent limit on family ownership in a rural bank through the Rural Bank Act of 1992 made it possible for the present family owner to consolidate its hold on the bank. The owner is a retired commercial banker who lives in the city of General Santos in Mindanao and owns a conglomerate of companies that include the rural bank, pawnshops, lending investors, a fishing company, and a real estate firm. The rural bank is in the hands of professional managers and has been transformed from a conservative operation in the sleepy farming town of Tupi to a bank with branch operations in other towns and the city of General Santos. The transformation took place after bank entry and branching were liberalized at the start of the 1990s.

After an eight-year effort to raise the required capital, Davao Cooperative Bank was established by members of farmers organizations, called *Samahang Nayan*, and non-agricultural cooperatives after a government policy intervention in the mid-1970s encouraged farmers to set up their own rural banks. None of the organizers knew banking; neither did the managers who presided over the bank's day-to-day affairs. After many growing pains and surmounted obstacles, the bank experienced remarkable growth. It is modernizing its operations and upgrading its system for city banking while continuing to develop its microfinance capability. Davao Cooperative Bank is today a model cooperative bank and ranks among the top five rural banks in the country.

Rural Bank of Digos is an example of a community-owned bank. Its 200 stockholders include small individual investors from the local communities of Digos, a sugar marketing cooperative, and a number of prominent families in the province of Davao del Sur. The majority stockholder is a businessman. Now in its 40th year, it is one of the oldest banks in the country, but it has just begun to grow by leaps and bounds under a professional manager.

## B. Inception and Historical Evolution of the System

Very little is known outside the Philippines about the Philippine rural banking experience. This section presents a chronology of the historical circumstances that accompanied its creation and the evolution of the policy context that finally gave way to the system's dynamism and vitality today. It does not attempt to apply historical hindsight to the events, but to present them as they occurred to bring the past closer to a proper understanding of present conditions and avoid interpretations colored by contemporary biases. The benefit of hindsight will be brought to bear in the last section to identify and assess the important lessons to be learned from the Philippine rural banking experience for the benefit of other countries.

### B1. A Chronological Retrospective

#### B1a. 1952-1972: Design and Implementation

The Philippine rural banking system is the product of supply-leading state intervention in 1952 to bring bank credit to a largely agricultural and restive countryside. This was the second attempt to encourage the creation of rural banks. A previous law in 1931 had provided for the establishment of rural banks, but resulted in the organization of two units that later failed.

The first rural bank created under the 1952 law was set up in 1953. The rural banking system was designed to rest on private initiatives backed by a program of government incentives. The Philippine government could have adopted the approach adopted by other developing countries of setting up a network of rural banks as state-owned entities or establishing a separate specialized bank for rural lending. But specialized government institutions in other countries have experienced a high rate of failure,<sup>3</sup> while the Philippine rural banking system has survived and is on the road to becoming a viable, sustainable, and growing financial network.<sup>4</sup>

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<sup>3</sup> One can also look at the Philippine's special government banks—such as the Development Bank of the Philippines and Philippine National Bank. In the past these banks were used by government for behest loans and favored groups that did not pay back their loans; these banks were bailed out by taxpayer money to survive.

<sup>4</sup>Not unlike the special government banks, the rural banks also experienced serious problems that led to the implementation of costly bail out packages. This issue will be discussed below. However, it is a central tenet of this study that such problems were due more to faulty government policy interventions than to the principles and institutional components that underpin the system.

**Rationale and objectives.** The Rural Bank Act<sup>5</sup> of 1952 was one law enacted by Philippine lawmakers that year to stem social and political unrest in a highly agrarian country and neutralize what was perceived as an unjust and usurious informal lending system.<sup>6</sup> The goal articulated in the law was to “promote and expand the rural economy in an orderly and effective manner by providing people of rural communities with the means to facilitate and improve their productive activities, and to encourage cooperatives”(see Box 2). Specifically, these rural banks were expected to provide adequate credit facilities to small farmers, small merchants, small rural enterprises, and cooperatives. The law defined smallness in terms of the size of the farmholding and/or capital investment. To accomplish its goals, the law assigned the government the task of encouraging and assisting in the establishment of a system of small banks that would place credit on reasonable terms within easy reach and access of the people.

**Design.** The 1952 Rural Bank Act allowed for the establishment of local, private, Filipino-owned stock corporations. Rural banks were intended as a means of meeting a broad sociopolitical and economic goal and allocating credit to targeted groups in rural communities. These entities were designed to be small regional unit banks whose owners and managers would come from local communities, thereby taking advantage of their knowledge of the locale as well as their reputation among local residents.

Since rural banks were meant to cater to the needs of their immediate vicinity, the law required only meager capitalization to set them up. It envisaged the eventual establishment of at least one unit rural bank per town. Therefore, rural banks were given the franchise for their particular municipalities. This was tantamount to giving them monopoly over a territory, a highly controversial provision discussed in a later section.

**Incentives.** To encourage private investments, the government’s package of incentives and assistance to the rural banking system was probably the most liberal and generous ever assembled to support the development of a rural financial market. This program of incentives should be viewed in the context of existing social and political imperatives and the prevailing financial policy climate at the time. There was great confidence that the underlying subsidies would benefit the rural population and that the implicit rents they generated would be offset by an interest rate policy that imposed ceilings on lending rates and floors on deposit rates.<sup>7</sup>

When the 1952 Rural Bank Act was enacted, rural areas were truly underdeveloped. Limited funds were available in the localities where the rural banks were organized; community savings were negative, and more money was flowing out of the rural communities than in. Even at the time of the economic recovery and high potential growth, business and investment funds continued to be concentrated in urban areas, particularly Manila. The challenge then, which remains today, was to reverse this flow and bring the funds where they were needed most, to the rural areas.

Source: Rural Bankers Association of the Philippines, *Four Decades of Service to Our People and Country* (undated).

<sup>5</sup> Republic Act No. 720 was approved by the lawmakers on June 6, 1952, and later amended a number of times. The latest version is the Rural Bank Act of 1992.

<sup>6</sup> Philippine House of Representatives, *Congressional Record*, Vol. III, No. 10, Manila, 1952, on the deliberations regarding the law.

<sup>7</sup> For example, an old anti-usury law made it a legal offense to charge more than 12 to 14 percent per

The incentives and special privileges extended to rural banks under the 1952 law, as subsequently amended, are depicted in Table 1 on the next page. The main policy elements were the low paid-up capital requirements and matching capital from the government, access to rediscounting funds, an all-embracing tax exemption privilege, and technical assistance programs.

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**year on loans. Moreover, the banking system was tightly regulated by a central monetary authority. This policy prevailed until the early 1980s.**

To encourage entrants into the system, the government, through a state-owned bank, matched private capital on an one-to-one basis in preferred, low earning non-voting shares. Later the policy limited the amount of government counterpart capital to P1 million per bank. During the earlier years, the paid-up capital needed for opening a rural bank was as low as 25,000 pesos (US\$12,000 at P2:US\$1), or one-tenth of the minimum capital (US\$100,000) required of a commercial bank. The minimum capitalization for a rural bank was subsequently adjusted a few more times, but remained comparatively small. This policy encouraged the proliferation of lightly capitalized rural banks, compromising the quality of services that such banks could offer in their franchise areas and predisposing individual banks to weaknesses in capital structure.<sup>8</sup>

Table 1. Exemptions and Privileges of Rural Banks, 1952 to 1980s,  
Under the Rural Bank Act of 1952, as Amended

Exemptions		Privileges	
Taxes, Charges & Fees	Other Exemptions from:	From Central Bank	From Other Gov't. Agencies
1. Income tax 2. Fixed tax for banks* 3. Documentary stamp tax 4. Tax on income of bank from lending (gross receipts tax or GRT) 5. Firearms tax 6. Deposit interest tax 7. Real property tax 8. All local taxes** except the annual business tax 9. Import tax on vehicles, equipment, etc. 10. Property registration tax 11. Docketing fees, sheriffs fee 12. Regulation fees for motor vehicles 13. Fees to the Securities and Exchange Commission	1. Registration fees, charges and documentary stamps on any instruments relating to transactions or loans extended by the rural bank  2. Publication in newspapers of foreclosure notices where the principal of the loan and interest due do not exceed P10,000	1. Free technical assistance (e.g., to install books of account and start-up operations)  2. Free training of bank officers in basic rural banking course  3. Free from management takeover expenses  4. Loan by Central Bank to rural bank on collateral assets of rural bank in emergencies and financial crises  5. Loan to rural bank through Central Bank of funds from int'l. lending institutions  6. Rediscounting from Central Bank	1. Access to advice on business and farm management from other gov't. agencies  2. Counterpart fund from the Development Bank of the Philippines (DBP)  3. Free notarial services by municipal and city judges  4. Borrowing from the DBP at 2% per annum up to term of 10 yrs.  5. Guarantee coverage of certain supervised credit program loans, for a fee

Source: Technical Board for Agricultural Credit (TBAC), "Rural Banking System: Is There a Need for Restructuring?" (c. 1980).

\*A fixed tax of P2,000, collected from franchise grantees and from banks, insurance companies, finance and investment companies doing business in the Philippines.

\*\*Such as transfer tax, building permit fee, municipal secretary's fee, market fees or rentals, tolls for roads, bridges, and canals, permit to engage in business, and residence tax.

<sup>8</sup> Technical Board for Agricultural Credit (TBAC) (c.1980).

Credit and rediscounting facilities at preferential rates were made available to the rural banks through state-owned banks and the Central Bank. During the latter part of the 1960s, the Central Bank rediscounting window became the system's primary source of credit funds after the Central Bank allowed rural banks to borrow P4 for every P1 in deposits and unimpaired capital. The advent of numerous government-backed supervised credit programs during much of the 1970s provided even more liberal access to cheap funds. This aspect will be elaborated later.

The original law exempted a rural bank from all taxes, charges, and fees if its net assets, excluding government counterpart capital, did not exceed a certain level. This level was eventually pegged at P1 million. A rural bank with assets of P1 million to P3 million had to pay a proportionate amount of taxes, charges, and levies on the amount in excess of P1 million. A rural bank with net assets over P3 million was no longer tax exempt. The blanket exemption meant that rural banks did not have to pay the corporate income tax (amounting to 35 percent), the 5 percent gross receipts tax, or import duties and taxes on vehicles and equipment.

After more than 30 years of the blanket tax break, the government withdrew the income tax exemption privilege in the 1980s. The tax breaks had become a counterproductive policy instrument that encouraged the rural banks to stay small (see Box 3).<sup>9</sup> Moreover, the privilege of duty-free importation encouraged its abuse.<sup>10</sup>

During the decade 1961 to 1970, the growth of rural banking business continued. The rural banks sought and obtained concessions from the government. Several amendments to the Rural Bank Act were made; several laws were passed that allowed the increase of the net assets ceiling of a rural bank so it could enjoy the tax exemption privileges.... These changes, however, failed to keep pace with the growth of the rural banking system. The tax exemption ceiling was not raised high enough to cater to the demands of growing banks. In fact, it limited the growth of some banks because the very incentives that were supposed to encourage growth proved instead to be deterrents to growth.

Source: RBAP, *Four Decades of Service to Our People and Country* (Undated).

#### Box 4. Conservative Bankers

<sup>9</sup> TBAC( circa 1980).

<sup>10</sup> This assessment was expressed by the officers of Supervision and Examination Sector III, Central Bank, during a meeting with the authors on November 7, 1995.

The Central Bank provided free technical assistance and training to bank officers and employees, who were required to attend a basic rural banking course. A technical person from the Central Bank also assisted in setting up the accounts of a newly opened rural bank, a job that usually took a week or two at no cost to the bank. The training and technical assistance continue to this day.

**Growth pattern.** The number of rural banks had increased to 18 by the end of 1953, and to 591 by 1972. The package of incentives was effective in encouraging more investments in small rural banks, judging from the growth indicators shown in Table 2.

The system experienced rapid growth during the first 10 years, compared to its conservative but steady expansion during the second decade. At the close of the 1960s, the system was having an impact on farm financing, as can be seen in Table 3. The participation of rural banks in countryside formal finance grew continuously.

“...rural bankers were often conservative lenders who extended credit only on a secured basis. This was the situation in the 1960s when past due ratios were low and most rural banks had healthy balance sheets. Understanding the state of rural banking then is important because the introduction of supervised credit became a major event that altered the risk rating of the banks' portfolio. This inevitably changed the future of many rural banks.

Source: RBAP, *Four Decades of Service to Our People and Country*, (undated).

During the second half of the 1960s, a supervised credit program was introduced on a pilot basis in rice-farming areas to start the dissemination of newly discovered high-yielding rice varieties. The program included access to credit funds at preferential terms from the Central Bank rediscounting window, supervision of rural bank lending by the agricultural credit technicians of the Central Bank, and supervision of farmers by government agricultural extension workers. The pilot project experience became the springboard for the largest government-directed credit program for farmers from 1973 to 1983.

Table 2. Selected Indicators of Performance, 1953-1972  
(Amounts in Million Pesos, Nominal & Real Value\*)

Indicator	Selected Years					
	1953		1962		1972	
	Nomin.	Real	Nomin.	Real	Nomin.	Real
No. of rural banks	18		224		591	
Increase (X)**			12X		2.6X	
Assets (Millions of Pesos)	2.4		140.4	2301.6	982.3	7796.0
Avg. assets/rural bank	0.13		0.63	10.3	1.8	14.0
Increase (X)**			4.8X		2.8X	
Capital Acct.(Millions of Pesos)	2.1		63.6	1042.6	287.9	2284.9
Avg. capital acct. rural bank	0.12		0.3	4.6	0.5	3.9
Increase (X)**			2.3X		4.5X	2.2X
Borrowing (Millions of Pesos)	0.2		29.5	483.6	330.7	2624.6



Ratio Borrowing to Assets (percent)	8.3		21.0		34.0	
Borrow increase (X)**			148X		11X	5X

\*Real 1988=100.

\*\*Times increase over year shown on left of column.

Source: Basic data from the Central Bank.

### B1b. 1973-1983: Co-optation and Near Destruction

The period that began in 1973 is a major epoch in the history of Philippine rural banking. It is referred to here as the *Masagana 99* (M99) era, because it played a major role in the evolution of the system. During the M99 decade, the number of rural banks increased by 75 percent, from 591 units in 1972 to 1,033 units by 1982, including more than 25 cooperative rural banks. It was also during this decade that the Central Bank, under restrictive guidelines, allowed rural banks to set up branches and field offices, resulting in the opening of about 49 branches by the end of 1982.

Table 3. Distribution of Formal Loans Obtained by Farm Households, Number and Amount by Source, 1960-61 and 1981-82 (in percent)

Source	1960-61		1981-82	
	No. of Loans	Amount of Loans	No. of Loans	Amount of Loans
Rural Banks	39.0	21.6	59.4	49.2
Philippine National Bank	16.8	46.4	19.5	18.3
Development Bank of the Philippines	10.6	20.7	4.0	17.8
Land Bank of the Philippines	-	-	7.0	8.6
Agricultural Credit Administration	-	-	5.1	3.3
Facoma/Agricultural Credit Cooperatives and Farmers Administration	15.9	3.5	-	-
Private commercial banks	0.9	1.6	0.5	0.1
Stock Savings and Loan Associations	-	-	0.3	0.3
Others	16.8	6.2	4.2	2.4
Total	100.0	100.0	100.0	100.0

Source: Sacay, Agabin, and Tanchoco (1985).

M99<sup>11</sup> is the program that the Philippine government launched in 1973 to attain self-sufficiency in rice, the major staple in the Filipino diet. *Masagana* is a Filipino word that means plentiful, and 99 refers to the target yield per hectare of 99 cavans of paddy. A high-yield and early maturing rice variety was first introduced to Filipino farmers as early as 1967 when it was initially grown in the country on a province-wide scale. The development of a series of varieties followed so that, by 1973 when M99 was implemented, the high-yield varieties were already well known to farmers. Circumstances at the time contribute to an understanding of the scale of the program's implementation and subsidies. A political regime had declared the country under martial law in 1972 when floods in Luzon and a long drought in Mindanao damaged much of the rice crop and produced serious food shortages. This national catastrophe coincided with global food shortages, frustrating the Philippine government's efforts to buy rice from the international market.

<sup>11</sup>During field interviews conducted by the authors, the phrase "Masagana 99" was on every rural banker's lips because of the program's negative impact on their banks.

As the staple food, rice is a political commodity in the Philippines. No government leader could ignore the potential sociopolitical risks that long rice queues could create.<sup>12</sup> Hence, to bring about rice

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<sup>12</sup>This is as true now as it was then, as evidenced by the recent rice crisis experienced under the current Ramos administration. President Fidel V. Ramos consistently enjoyed high public satisfaction ratings as shown in the public opinion polls taken regularly by Social Weather Stations. But the domestic rice shortage in mid-1995 caused public satisfaction with the national administration to plunge to its lowest level so far.

sufficiency as quickly as possible, the government mounted the M99 program to accelerate the adoption of high-yield varieties by farmers. Despite its many elements, M99 can be regarded primarily as a credit program. Most of the services provided through the program accompanied loans extended to farmers (see Box 5).

Credit was the most expensive component of M99, not only in terms of the outright subsidies that went into the program<sup>13</sup> but, more important, in terms of the institutional damage it wrought on the rural banking system. This study will not dwell on the costs and benefits of the program, which have been the subject of a number of previous works. Instead, it will focus on the participation of the rural banks and the problems they experienced in the program's aftermath.

Rural banks were called on to serve as major conduits of unsecured loans to small rice farmers. To start up their lending, the Central Bank made special funds available to rural banks at 3 percent per year. The banks could then return to the Central Bank rediscounting window and rediscount the loan for 100 percent of the loan value at 1 percent, and later 3 percent, per year. The lending rate on unsecured loans to farmers was pegged at no more than 10 percent, later 12 percent. As another sweetener to entice rural banks to the program, arrears under M99 were excluded from the computation of the bank's past-due ratio. Under the Central Bank's prudential regulation, the past-due ratio should be no more than 25 percent. Under normal conditions, a rural bank would have been barred from borrowing from the Central Bank when this ceiling was exceeded. The exemption ensured the continued availability of credit funds to farmers. The loans were also covered by a government guarantee scheme to protect the banks against non-repayment of loans in the event of calamities. The government farm technicians assisted in canvassing farmer-borrowers and, in effect, screened the loans.

M99 is without doubt the most extensive agricultural production program ever planned and implemented in the Philippines. It utilized the services of some 6,000 [agriculture] technicians; the entire rural credit system; and hundreds of millions of pesos for production credit, fertilizer subsidies, price support, and irrigation development stretched over a period of several years. Started in 1973, the program reached as many as 530,000 farmers at one time, or roughly one-third of all rice farmers in the country. Rice self-sufficiency was attained by the country for the first time during the initial years of M99 implementation.

Quoted from Sacay, Agabin, and Tanchoco, *Small Farmer Credit Dilemma* (1985).

The Central Bank used incentives and moral persuasion to convince rural banks to participate as credit conduits. But these were combined with a threat to open the territory to new rural banks if the existing bank refused to cooperate. As stated before, the policy of one unit rural bank per municipality gave the bank a monopoly over a territory. Thus, many rural bankers were motivated to participate not purely by opportunities for profits and rent-seeking, but also for fear of being punished. There were also bankers interested in helping the country overcome an explosive crisis.

There were different levels of participation, experiences, and results. At one end were rural bankers who threw out caution altogether and adopted an entirely new style of lending unsecured loans to farmers they had barely screened; they also depended on the recommendations of government technicians in screening and post-loan supervision. At the other end were rural banks that participated more cautiously. They carefully screened their borrowers and saw to it that the loans

<sup>13</sup>This aspect is well discussed in Sacay, Agabin, and Tanchoco (1985).

were somehow secured; they hired their own farm technicians for post-loan supervision; they watched their financial ratios and closely guarded the recovery of loans; they calibrated the extent of exposure to the government credit programs; and they did not neglect lending to their traditional clients. These cases are depicted by the examples in Box 6.

Box 6. M99 Rural Banks: Two Cases

Case 1. The Community Rural Bank of M, owned by farmers and community leaders, is a 21-year-old bank that is still grappling with the problems and consequences of having participated in M99. A newly opened bank at the time of the program, it disbursed M99 loans to rice farmers in rainfed farming areas. As a new bank it was inexperienced and had untested management capability. The bank relied mainly on government guidelines and the agriculture technicians assigned to help it. Some farmers treated the loans as handouts; some loans were fictitious; but, in fairness, low prices of paddy and low yields due to calamities and pests also affected loan recovery. The bank did not know how to mobilize deposits. Its capital was meager. Lacking the resources to lend, it had to cut back its loan operations. Because of M99, close to half of its loan portfolio consists of uncollected loans.

Case 2. The Community Rural Bank of SI was established by several families in a farming town the year M99 was launched.

“The bank benefited from the government-supervised credit programs,” declared the manager, a dynamic and astute businessman who is one of the bank owners. The bank began to participate in M99 during the program’s first year. Its management thought the bank would be able to collect because of martial law or, if not, the government would be prepared to bear the cost of default.

As it happened, the bank made the M99 lending operation profitable. What made the difference for this bank? As the manager explained, “The community in which we operated was small but had excellent irrigation facilities. We were familiar with the borrowers, whom we supervised closely. We hired our own farm technicians, whereas most rural banks depended on government technicians. We had a mechanism in place to ensure the repayment of loans. Besides, we did not regard M99 credit as a major product; we never exposed more than P2 million or what the bank could supervise. We continued with the sound loan portfolio of our regular lending program, which made up the bulk of the bank’s portfolio. There were at least 33 rural banks in our province, which is a leading rice-producing area, but they were either decimated or suffered greatly due to their M99 involvement.”

What about deposits mobilization during the M99 era? “We did not pay much attention to this because it was easy to get government funds at a cheap rate. We were not too motivated to develop our internal source of funds. But later, when there were problems with the M99 program and the Central Bank started tightening its rediscounting window, we decided to pursue a different direction to make viable investments. It was easy for our bank to make the adjustment because we had no arrears problem with M99 and other supervised credit programs.”

Field interviews conducted by the authors, various dates, November 1995.

By 1983, the M99 program had run its course and faded quietly away. Other directed credit programs experienced the same fate. In later years attempts were made to reincarnate the credit program for rice in other forms, but they did not last long enough to make an impact. The directed programs for agriculture wreaked havoc among rural banks that participated massively in these programs. Furthermore, the rural banks had to contend with adverse economic conditions. Aggravated by a severe recession abroad, the Philippine economy was buffeted by high inflation, a liquidity crisis, trade imbalances, large and ballooning fiscal deficits, and a widening balance of payment deficit. These problems led to contractionary monetary policies and to the partial liberalization of the financial system in the early 1980s. These measures could not, however, prevent

a major crisis of the financial system. Six major commercial banks collapsed and were placed under government control. A growing tide of disaffection with the martial law regime spawned rising political instability.

In spite of these problems, by the early 1980s the rural banking system remained the major institutional source of farm credit, reaching about 60 percent of formal debtors and supplying about half the value of formal loans (Table 3, p. II-10). But the signs of distress were unequivocal: at least 70 units had ceased operating or were forced by the Central Bank to close at the end of 1983. Some visionary bankers, realizing that becoming big was key to the rural bank's survival, engineered the merger and consolidation of 14 rural banks in the province of Bohol, an operation that drew the encouragement and support of the Central Bank.<sup>14</sup> But this was just a tiny bright spot amid overall chaos and despair. Considering the distressing economic and political climate and the public's shaky confidence in the system because of the spate of closures, could the rural banking system survive? More than a few people entertained the idea that the system was ready to be written off.

#### B1c. 1984-1992: Crisis and the Rehabilitation Programs

From 1979 to 1982, at least three assistance programs were implemented to help rehabilitate the rural banks. These early programs used a combination of instruments that included: (a) capital build-up; (b) government matching of additional capital through the conversion into preferred shares of an amount equivalent to the arrears with the Central Bank ; (c) restructuring of end-user loans over five years and an equivalent restructuring of the bank's arrears with the Central Bank; and (d) forgiving of the penalties and liquidated damages by the Central Bank. Furthermore, a 10-year loan for investment in yield-earning financial instruments was offered to rural banks, so the income could be used to absorb losses that a rural bank would incur from eventual loan write-offs. But these earlier bail-out instruments proved to be mere palliatives because the problems recurred as restructured loans to end-users matured. Moreover, it proved to be difficult to motivate owners to raise fresh capital and attract new investors.

The rural banks were unprepared for what lay ahead. Their major source of credit funds, the Central Bank rediscount window, dried up and virtually closed in 1984. The economy was in its worst period of depression amid political crisis after the assassination of a major political figure the year before. Inflation soared to 48.4 percent in 1984, and private commercial banks were crowded out by a government that chose to finance its operations with private savings in the form of high-yield treasury bills.

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<sup>14</sup>The bank, First Consolidated Rural Bank of Bohol, is now one of the biggest, strongest, and well-managed rural banks in the system, with 26 branches and assets close to a billion pesos. The bank services 79,000 savers and 22,000 borrowers.

During 1984 and 1985, the rural banking system's real assets plunged, and so did total capitalization. Deposit liabilities, which declined nominally, dropped substantially in real value. Of the 1,040 operating rural banks in 1981, the Central Bank closed some 250 units, including those that were the weakest or otherwise unworthy of doing business.<sup>15</sup> The Central Bank also stopped licensing new rural banks, although it allowed some rural banks limited branching.<sup>16</sup> By 1986, the number of rural banks declined further. About 80 percent of those still in operation had rediscounting arrears with the Central Bank, while 13 percent had negative net worth. On the assets side, 72 percent had portfolios with more than 25 percent of loans already past due. In terms of profitability, 36 percent had operations in the red.<sup>17</sup>

A year after a new government was installed in 1986, a fourth bail-out program for the rural banking system was launched in response to the rising feeling of despair and alarming incidence of rural bank closures by the monetary authority. It was time for the government to “bite the bullet,” so to speak, and plans were drawn up for a new rehabilitation program that would put the troubled banks back on their feet. The 1987 Rural Bank Rehabilitation Program under Central Bank Circular 1143, as Amended, aimed to strengthen the rural banks through a combination of fresh capital infusion and the rescheduling of past-due obligations with the Central Bank. Table 4 below presents the principal features of the program.

Table 4. Principal Features of the Rural Bank Rehabilitation Program  
(Central Bank Circ. 1143, as Amended)

1.	Fresh capital infusion to achieve the minimum 10 percent risk asset ratio
2.	Option for conversion of supervised credit arrears into common stock in the name of the Land Bank of the Philippines, and/or plan of payment with the Central Bank not exceeding 15 years
3.	First option to purchase the common shares held by the Land Bank under the conversion scheme, under certain conditions
4.	Increase in authorized capitalization
5.	Forgiveness of liquidated damages and/or penalties under certain conditions
6.	Restoration of rediscounting privileges
7.	Exemption from the equity ceiling on family ownership

Source: Central Bank Circular 1143, as Amended.

<sup>15</sup>By 1981, a total of about 300 rural banks had been closed or placed under receivership, according to officials of SES III of the Central Bank.

<sup>16</sup>Licensing of new rural banks resumed only after the policies for entry and all-out branching were liberalized in 1992.

<sup>17</sup>Joseph Y. Lim and Meliza H. Agabin (November 1993).



Some 500 rural banks were estimated to be in arrears with the Central Bank as of the end of 1986. The Rural Bank Rehabilitation Program was to be implemented over a period of at least five years and targeted about 300 to 350 applicants from the rural banks in dire need of rehabilitation. Some 200 rural banks were also estimated to need fresh capital infusion in excess of P1 million to be admitted to the program. Table 5 shows the status of the program at the end of 1992.

The rehabilitation program had a mixed impact on the financial soundness of rural banks. The banks that benefited from the program were those that already had capable management and strong performances in deposit mobilization and portfolio management. Many others, however, did not recover as decisively as policy makers expected.

Table 5. Applications, Approvals, and Participation  
Under Central Bank Circular 1143, as Amended, as of November 1992

Item	Number of Rural Banks
Total applications received	525
Approved applications	488
Applications denied/withdrawn/disqualified	29
Applications Deferred	8
	<u>In Pesos</u>
Principal amount of arrears with Central Bank covered under Central Bank Circ. 1143	P1.83 Billion
-Principal paid as of end 1992	P0.62 Billion
-Converted to equity of Land Bank of the Philippines	P0.25 Billion
-Under plan of payment	P0.98 Billion
Number of rural banks that infused new capital	431
Amount infused	P0.53 Billion
Average amount infused/rural bank	P1.22 Million

Sources of basic data: Central Bank; Land Bank of the Philippines

In 1991, the Countryside Financial Institutions Enhancement Program (CFIEP) was assembled as the fifth attempt to rehabilitate rural banks. Its specific objective was “to reduce the debt burden of eligible countryside financial institutions.” The decision to mount the CFIEP was based on the finding of a 1990 study that some 65 percent of operating rural banks were equity deficient as of June 30, 1990.<sup>18</sup> Policy makers were faced with two options. The first was to restore these banks' risk assets ratios to at least 10 percent, which required an additional infusion of capital for some P1.26 billion. The second was to close the equity deficient banks, but it was argued that this option would result in tremendous economic dislocations, the loss of institutional capacity, and significant financial losses. Potential losses to the Philippine Deposit Insurance Corporation were calculated at P4.32 billion, and potential arrears to the Central Bank were estimated at P2.44 billion.<sup>19</sup> Not surprisingly, decision makers chose the first option.

The prominent features of CFIEP are listed in Table 6. Significantly, CFIEP exempted common stockholders from the 20 percent ownership ceiling in a rural bank and waived the penalties and other charges on arrears covered by the program.

<sup>18</sup>A joint study by the World Bank, the Philippine Deposit Insurance Corporation (PDIC), a state agency insurer of deposits in banks, and the Central Bank (November 1990, unpublished).

<sup>19</sup>From “Proposed Guidelines on the Implementation of a Comprehensive Rural Bank Strengthening Program Through the Formation of a Rural Bank Capital Build-Up Fund,” March 15, 1991.

Table 6. Features of the Countryside Financial Institution Enhancement Program

Module I	Purchase of Rural Bank arrears (two for one). This module seeks to retire some P2.8 billion of rural bank arrears with the Central Bank. One peso of new capital from owners will retire two pesos worth of arrears with the Central Bank.
Module II	Land Bank counterpart capital (one for one). Under this module an eligible rural bank is given access to the Land Bank's capital infusion program. A rural bank's fresh capital infusion is matched on a one-to-one basis by the Land Bank, in preferred shares redeemable over 10 years.
Module III	Merger and consolidation incentives. This module seeks to promote mergers and consolidations among banks as a means to "develop larger and stronger countryside financial institutions." The incentives include, among others, a counterpart capital infusion by the Land Bank by a ratio of more than one to one of the merged or consolidated bank's total fresh equity, and a Philippine Deposit Insurance Corporation credit facility to augment the required capital infusion and to absorb the adverse impact of asset write-downs and other merger and consolidation costs.

Source: Central Bank Circular 1315, 1991.

The program, which was implemented over three years, made possible a generous resource transfer in favor of rural banks. This explains why rural bankers who took advantage of the program extol its virtues and attribute to it the "fast tracking" of their rehabilitation (see Box 7). No evaluation of the CFIEP has been done but, based on extensive field interviews, the program appears to have helped rural banks gather the strength to position themselves for expansion, diversification, and improvement in the quality of their services. The quick and the agile, and those with the resources for

Box 7. CFIEP and the Case of Rural Bank NB

kicking in fresh capital, seemed to have benefited most from the

Rural Bank NB has just completed three years of rehabilitation under the CFIEP. The bank was formed from the merger of six unit rural banks after its owners took advantage of all three modules offered under CFIEP. Under Module I, its owners infused P12 million in new capital to retire P24 million in arrears with the Central Bank. Under Module II, for the same P12 million in new equity, the Land Bank infused matching capital amounting to P9 million. The result is a total capital increase of P33 million, of which P12 million has been recorded as paid-in surplus. The latter is restricted surplus and cannot be declared as dividend, but it improves the bank's net worth. Under Module III for merger and consolidation incentives, the Philippine Deposit Insurance Corporation granted a loan of P75 million to buy treasury notes whose income is four percentage points more than the interest rate on the loan. The treasury bills are held by PDIC as collateral for the loan. The four-point spread is supposed to build up retained earnings to allow for write-offs of bad loans. Most of Bank NB's bad loans originated from unsecured lending under the government's previous supervised credit programs.

The six units banks from which the Rural Bank NB was formed were money losers before the merger. They were poorly located and badly managed. Four years ago a professional and dynamic manager was hired to revamp them. This manager presided over the merger and rehabilitation process. The merged operations began in July 1993 and the bank, with 10 new branches, is bigger and stronger today. In a two-year span its assets and loan portfolio have more than doubled, and deposits have grown by 70 percent. In addition, income has increased from P2.3 million to P12 million, and the past-due ratio has declined from 38 percent to 12 percent.

program. By the same token, those who most needed the CFIEP's assistance were unable to access it, primarily because their owners lacked the resources for new capital injection and/or their management was slow to act.

Following the implementation of the CFIEP, a sixth scheme has been incorporated under the Rural Banks Act of 1992 and is intended for those unable to participate under the CFIEP. The scheme spelled out in the law provides for the conversion of a rural bank's arrears with the Central Bank (arising from past government programs plus 50 percent of nongovernment credit arrears) into government-preferred stocks in the bank. Owners must infuse an equal amount of capital, which can be paid in annually over 15 years.<sup>20</sup> If anything, this sixth package underlines the government's commitment to a complete overhaul of rural banks. And not unlike the five programs that preceded it, it is vivid testimony to a crisis that rocked the foundations of the entire system.

#### B1d. 1993 to Present: Recovery and Expansion

The number of rural bank offices declined by 1.4 percent from 1985 to 1990 as a result of closures and the fact that the Central Bank allowed no new rural banks to open. Still, by the end of 1992, 787 rural banks with 354 branches were reaching out to about 463,000 borrowers and at least 1 million savers. Their assets totaled P11 billion (US\$431 million). In 1992 the entire system registered positive real growth rates in assets, capital accounts, and net loans, thus reversing the sluggish if not negative growth trend of previous years. What caused this impressive turnaround and the subsequent expansion of the rural banking system? Other than the probable favorable impact of the generous subsidies contained in the CFIEP rehabilitation program, three basic factors can be identified: (a) the

<sup>20</sup>Information on the impact of this program has yet to be made available.

financial liberalization reforms that encouraged market-directed operations and all-out branching; (b) the professionalization of the management of rural banks; and (c) a more vibrant economy that has been growing at a respectable rate in recent years.

The early 1990s saw the liberalization of bank entry and branching as well as the passage of the revised Rural Bank Act. The new rules of the game reflect a firm commitment to let rural banks compete freely in the market. This new financial environment also allows 10 new foreign banks to enter the market with full banking authority and the right to establish three branches each. The entry of foreign banks has created anxiety among some rural banks, because the foreign concerns are expected to compete for commercial business, thus probably leading local commercial banks to downscale to markets that rural and thrift banks usually handle. In fact, experts believe that the Philippine financial system is already witnessing some downscaling. The bigger and more aggressive rural banks have taken stock of this possible trend and are gearing up for what promises to be more heated competition.

As can be expected, the response of rural banks varies to the new policy and economic climate and its ensuing opportunities. At one end of the spectrum are strong rural banks that are growing by leaps and bounds and behaving as true financial intermediaries. An exceptional few have entered the realm of commercial banking as regards lending and deposit mobilization. In terms of leadership, these units are innovating under highly capable managers and finding their market niches. Their managers are either second generation bankers or hired professional managers who apply corporate practices, basic business principles, and modern systems to rural banking. This new breed of rural bank managers share a number of characteristics: they are dynamic and innovative, they strongly believe in the advantages of institution-building, they do not spare resources in upgrading the skills of their personnel, and they have a commitment to rural areas and small clients (Box 8).

Case 1. Mr. X is a second generation banker who managed his family's bank for many years before becoming the professional manager of a network of unprofitable rural banks. An economist by academic preparation, his progressive ideas and innovative approaches to rural banking and management helped him in encouraging the owners to merge and consolidate the banks under a government rehabilitation scheme, infuse additional capital into the banks, refurbish the bank's image, develop and train staff, and modernize the system. The bank has opened 10 branches and doubled its assets, loans, and deposits in the three years since the merger. Mr. X is guided by his vision of turning the rural bank he manages into one with the biggest network, mobilizing resources within the region so they can be used in the region.

Case 2. Mr. Y became the second manager of a problem-ridden cooperative rural bank in 1985. He had no banking experience when he started, but has succeeded in making the bank one of the top five in the industry after strengthening it by aggressively gathering deposits, opening its credit services to the general public, diversifying its portfolio, modernizing its systems, training bank staff, and applying basic business principles to the bank's operations. A visionary and action-oriented manager, he has applied hard work and intelligence to the task. The bank has four branches and plans to open two to three more branches in the next two years; its manpower has increased to 145 employees; its resources, loans, and deposits have increased manifold.

Case 3. Mr. Z is a retired officer of a commercial bank. In 1992 he became a consultant to a 15-year-old rural bank in Southern Mindanao, and in 1994 he became its executive vice president. The bank is owned by one family, which has investments in varied business interests. The bank used to operate in a small agricultural municipality, where it supplied rudimentary banking services. In 1992 it started to set up branches. It now has six branches in six towns, including one in the major growth city of General Santos; two more branches are opening soon, and five more are planned, all in the Mindanao region. The bank has beefed up not only its capital base, but also its pool of professional bankers. Moreover, the bank's internal system has been modernized, the staff trained, offices refurbished, planning and budgeting processes

At the other end of the spectrum are very weak units that are still being run the traditional way by owners or managers who resist change. These units are still finding their way out of a problem-ridden past, but their efforts are often smothered by management incompetence and ignorance. The majority, however, have begun substantive change or are about to engineer a significant turnaround with the help of additional capital infusion, more aggressive deposit mobilization, and the generation of more diversified, sound loans. These banks have also sought professional managers or have a second generation of younger and more aggressive banker-owners at the helm of their operations.

The number of rural banks has remained more or less constant. New entrants have appeared, but some rural banks have merged or consolidated into bigger units.<sup>21</sup> Significantly, however, the number of branches has increased substantially since 1992. Rural banks are expanding their outreach by opening up more outlets. And, as will be demonstrated below, the rural banking system in general seems firmly on its way to gathering more deposits, and many units are implementing innovative methods of mobilizing small savings. Although their loan portfolios have become more diversified, they have not abandoned agriculture but have only rationalized their lending for farm projects. Unsecured loans are becoming a thing of the past. These findings will be discussed in a later section.

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<sup>21</sup>According to the Central Bank's definition, consolidation takes place when all corporate identities of the units are abolished, and a new corporate entity is created and absorbs them all. On the other hand, a merger takes place when an existing unit survives and absorbs the rest.

## B2. Present Legal Framework for Rural Banking

As noted above, the present policy climate is more market friendly than in the past. It therefore fosters the development of finance. Nevertheless, the process of reforming the Philippine financial system has yet to be completed. Ill-conceived policy interventions are still the source of appalling inefficiencies. To wit, the law mandates banks to allocate credit to specific sectors, and more than 100 government-sponsored credit programs introduce unnecessary distortions. Legal reserve requirements are still high, despite downward adjustments made in 1995. Such statutory reserve requirements, however, are lower for rural banks than for commercial banks.

At least three loan portfolio allocation policies are sources of controversy. The first is the so-called Agri-Agra Law, which originated in the 1970s and requires banks to lend 25 percent of their loanable resources to agriculture and agrarian reform beneficiaries. The second law, called the Magna Carta for Small Enterprises (1991), requires banks to allocate 15 percent of loanable resources to small rural enterprises. And the third provision obligates banks to lend a certain percentage of the deposits they mobilize in the region where they are located. Compliance with these laws is monitored by the Central Bank, and non-compliance is considered a violation. These quota policies are contrary to the spirit of market-directed reforms. Moreover, past experiences with the forced allocation of credit for agriculture and agrarian reform farmers have proven ineffective in re-directing credit flows and have succeeded only in increasing the costs of intermediation and in distorting loan reporting. The repeal of these provisions has been recommended many times before.

At least nine separate laws govern the operations of different types of banking entities in the Philippines. Following the financial reform process that started in the early 1980s, all the laws have been revised or amended, including the Rural Banking Act of 1992, which provides the legal basis for the creation, organization, operation, and regulation of rural banks.<sup>22</sup> The Rural Bank Act of 1992 is as much the product of 40 years of experience in rural banking as of political lobbying and negotiations among major stakeholders and government policy makers. The current law retains many of the features of the old one (see Annex A), but allows for the introduction of a few major changes. The most notable features that have been retained are the following:

- The peso-for-peso matching of capital for new entrants

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<sup>22</sup>In addition, the Cooperative Code of 1990 contains provisions specific to cooperative rural banks.

- Supplemental capital infusions from government financing entities such as the Land Bank and the Development Bank of the Philippines<sup>23</sup>
- Time-bound tax exemption status, until 1997, regardless of net worth. This privilege exempts rural banks from the payment of all taxes, charges, and fees, except for corporate income tax and local taxes and fees.

Annex B compares the functions a rural bank can perform with those of other banks. Certain limits are placed on the investments of a rural bank as on other banks: (a) a rural bank's total investment in equities cannot exceed 25 percent of its net worth; (b) the single borrower limit cannot exceed the current ceiling of 25 percent of net worth (as determined by the Central Bank); and (c) the amount of credit accommodation to a rural bank's director, officers, stockholders, and related interests (DOSRI) is pegged to the amount of their deposits and the book value of their paid-in equity in the bank. This latter regulatory provision is meant to protect the bank from being raided by DOSRI interests.

The law gives the Central Bank the flexibility to change the minimum capital requirements when necessary. Depending on its location, a rural bank's minimum capital requirement varies from P2 million (US\$77,000) to P20 million (US\$770,000) (see Table 7). Although this represents a significant improvement with respect to the dangerously low capitalization requirements that prevailed in the past, the current minimum remains tiny compared to the minimum US\$48 million needed by a regular commercial bank.

Finally, the most noteworthy new features of the law are the following: (a) the provision of incentives, enforced for the period 1992 to 1995, for the merger and/or consolidation of at least five rural banks located in the same region; (b) the availability of rehabilitation packages to wipe out arrears with the Central Bank; and (c) the granting of exemptions from the 20 percent ownership ceiling until the year 2002.

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<sup>23</sup>The decision to infuse or not to infuse capital now rests on the particular government entity, more concretely on the availability of funds from its internal budget. For instance, with the possible exception of new cooperative rural banks that draw capital matching assistance from the Land Bank, this government bank currently does not respond to applications from new entrants for matching capital because it does not have the budget to do so. This has been interpreted by many observers as proof that the new financial policy framework—which downplays subsidies and expects rural bankers to rely on their own resources—rules. For many others, this also underlines the government's recognition that rural banking has evolved into a sunrise industry.



### C. Ownership Arrangements

Only Filipino citizens, corporations, associations, or cooperatives organized under Philippine laws may own the capital stock of a rural bank. As a rule, rural banks are family owned, while a minority are controlled by cooperatives. Both commercial and thrift banks can set up rural banks as allied undertakings.<sup>24</sup>

Table 7. Minimum Capitalization Requirements for Rural Banks,  
by Type of Municipality, as of January 1996

Category of Municipality/City	Minimum Paid-in Capital (Pesos Mil.)
a) In 1st, 2nd, and 3rd class municipalities	P5
b) In 4th, 5th, and 6th class cities; in 2nd, 3rd, and 4th class towns	3
c) In 5th and 6th class municipalities	2
d) In cities/selected municipalities in Greater Manila Area*	20
e) In the cities of Cebu and Davao*	10

\*Current Central Bank guidelines disallow rural banks from opening in these places.

#### C1. Family-Owned Rural Banks

Property rights of family-owned rural banks are well defined, incentives are clear, and management's mandate to make profits is unambiguous. And because their owners usually come from the local vicinity, they have an intimate knowledge of the place and the people. As a result, the problem of information asymmetry is virtually nonexistent.

To prevent any one family or individuals from dominating the local economy or, more specifically, from "abusing the bank," the law used to impose a limit of 20 percent on a family's ownership in a rural bank. There were creative ways of getting around the family ownership ceiling, however, such as using proxies. The government's decision in 1992 to temporarily suspend the ownership ceiling on rural banks probably reflected the difficulty of enforcing this provision, but served more as a measure to rehabilitate rural banks and motivate major stakeholders to infuse new capital. Since then, a few rural banks have become one-family entities. Theoretically, the advantage

<sup>24</sup>The United Coconut Planters Bank, a private commercial bank with expanded authority, has established its own rural bank network to downscale its products to reach a smaller clientele and comply with loan portfolio allocation policies, and/or to take advantage of the tax exempt privileges, including exemption from the 5 percent gross receipts tax, and lower reserve requirements.

of a family-owned bank is that the decision-making process is quick, and owners can respond to calls for additional capital by digging into their deep pockets to protect their investments in the bank.

It is difficult to generalize about family-owned rural banks because they are as varied as their owners or controlling interests. The owners, and hence their banks, range from the most progressive and prosperous to the more conservative, as described in Box 9. An undetermined number of rural banks are community owned, but some of these banks have at least one controlling interest who calls the shots. In other cases, bank ownership may be diffused among individual investors, and property rights ambiguous. This type of entity has something in common with the cooperative rural banks.

## C2. Cooperative Rural Banks

Because of the diffused ownership and cooperative nature of the (CRBs), several issues have arisen since the creation of the first CRB in 1973. The first issue has to do with responsibility, accountability, and commitment. The lack of controlling interests to watch over the performance of a CRB can, as has been painfully demonstrated in the past, encourage economic rent-seeking if not outright corruption in borrowers and managers, especially when the latter are accountable to no one, and when the bank's internal control and accounting procedures are loose.

The second issue is management stability. A CRB is governed by the democratic principle of owner participation through the general assembly and representation on the board. The inherent danger is that the board composition can change anytime and thus introduce an atmosphere of uncertainty that undermines the stability of management. In fairness, this scenario is more theoretical than real in the Philippine setting, as many owners, gripped by inertia and handicapped by a lack of technical knowledge, prefer the coziness of “muddling through” to the anxiety of strict oversight. Therefore, a good manager whose CRB performs well will be assured a long tenure. Of course, the downside is that a bad manager could also stay for a long time and thus bring lasting damage to the bank.

The third issue concerns the regulation of the single borrower limit (SBL) and loans to directors, officers, stockholders, and related interests (DOSRI). As presently prescribed by the monetary authority, the SBL cannot exceed 25 percent of the net worth of a rural bank. On the other hand, a DOSRI borrower is defined as a stockholder owning 2 percent or more of the subscribed capital stock of the bank. As noted above, a loan to a stockholder is limited to the respective outstanding deposits and book value of the paid-up capital contribution held by the stockholder in the bank. But this limit poses huge problems for CRBs, which are established to serve owners that normally have small equity contributions and deposits in their bank. Since the funding requirements

Case 1. Rural Bank of MZ is owned by a family who bought it from its original owners more than five years ago. This bank is headed by an aggressive rural banker who also has a major stake in other rural banks. Before the Rural Bank of MZ was sold to its present owner, it was a stagnant, conservative bank with an absentee manager. But it became one of the best rural banks in the province of Nueva Ecija five years after the takeover. A professional lady banker manages it, but the owner is active in decision making and in packaging products and services.

Case 2. Rural bank of MBY is 39 years old and owned by one family. It is still run by its original founders, a husband and wife, who have kept the bank deliberately small. With assets of barely P5 million, it reaches fewer than 500 borrowers and an equal number of depositors. Despite its pressing problem of inadequate paid-up capital, the family is averse to new investors for fear of losing control of the bank.

for cooperative projects may well exceed the limit imposed on DOSRI loans if not the SBL, the CRBs cannot adequately respond to the economic projects of cooperatives unless they commit a major violation of prudential regulations. Not surprisingly, managers of successful CRBs are lobbying the Central Bank to suspend the SBL and DOSRI ceilings. There remains the larger issue of whether the existing legal framework that governs financial entities must take into account the unique characteristics of CRBs and, accordingly, establish different rules for them concerning prudential norms and supervision.

Notwithstanding these impediments, the most recent Philippine experience in cooperative banking suggests that banks owned by ordinary folks, farmers, and the poor can become successful, provided they are endowed with an excellent and highly committed management. A friendly policy environment is also a necessary condition for success. In all, the historical evolution of these units has provided valuable lessons. One lesson relates to the relationship between capital build-up and client diversification. When first established in the mid-1970s, most if not all CRBs were dominated by borrowers, a condition that severely limited their capital growth and hence chances for long-term survival. The first units were established with meager funds by small rice and corn farmers through village associations, although like the family-owned rural banks, they received matching capital from the government. A nagging problem they faced was that concentrating on servicing only their investors and members proved limiting and risky, because most were engaged in agricultural activities. Later, when the minimum paid-up equity requirement was increased, their ownership expanded to include non-agricultural cooperatives, because their original investors did not have the resources for additional equity infusion. Not only was capital raised, but the decision to invite outside cooperatives sparked an interest in diversifying the clientele beyond the original membership and investors, a policy change that eventually resulted in a faster expansion of assets and capital.

The earliest CRBs went through growing pains inflicted by inexperience, bad management, and a market confined to risky target clientele. The good news is that even difficult cases later turned around after dynamic, hardworking, dedicated, and committed individuals, who also had sharp pencils and visions, took over the management of these banks.<sup>25</sup> The evidence also suggests that the trend among CRBs to open up their credit services to the general public has been recognized by managers as a matter of survival and good banking business. Furthermore, the CRBs are moving away from a dominance by borrowers into campaigns to attract more savers.

#### D. Organizational Design

Aside from regulatory constraints, rural banks are autonomous institutions that are free to design their organizational and delivery systems to suit the locale in which they operate and their management styles.

A study completed in 1980 at the request of the Governor of the Central Bank described the internal organization of rural banks as follows:<sup>26</sup>

“The most serious deterrents in the development of the rural banks are the absence of high caliber, professional bank management, the low quality of bank staff, and the lack of honesty and dedication to effectively provide satisfactory banking services to the

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<sup>25</sup>Meliza H. Agabin and Orlando Sacay (1996a and 1996b).

<sup>26</sup>Op. cit. (c.1980).

community. The inadequate supply of trained manpower in the rural areas, especially in the economically depressed regions, the low remuneration levels which cannot attract and maintain good people, inadequate training programs, laxity in the process of qualifying future rural bankers, etc., are the major causes of the problem [of the rural banks]. The effects of these problems are far more grave—inadequate services to the target clientele, inefficient banking operations, anomalies, erosion of public confidence in the bank, and sometimes bank failures.”

Although these problems still exist in some units, the trend is unmistakably in the right direction. Most units are taking steps to correct glaring deficiencies and, as a result, the system has a number of banks that have already acquired professional management, systematized and modernized internal policies and processes, and adopted more stringent performance standards than the minimum prescribed by the Central Bank.

### D1. Location

As a rule, rural banks are located in the communities in which they operate. The most successful have been established strategically, close to vast retail markets and commercial centers where most of their clients make their living. Such was not always the rule, however, especially among units that were established in agricultural towns. Now that the system has been opened to competition, a good number of banks have found it necessary to relocate, while others have opted to renovate their offices including, in some cases, installing expensive air conditioning systems.

In general terms, the offices are unassuming. Still, they may seem overwhelming to the poorest rural customers, who are usually intimidated by well-dressed bank officers.

### D2. Staffing and Incentives

Rural banks have as few as six or seven staff per outlet, which is the minimum number of employees with appropriate skills prescribed by the Central Bank. Other units have as many as 17 per outlet. Assuming an average of 10 employees per outlet, which is probably a low estimate, the rural banking system (with 1,274 outlets in 1994) employs at least 12,740 men and women whose educational qualifications have improved over time.

The incentive systems in rural banks have also improved. Some units now pay competitive salaries to their employees. A few are able to provide salary packages that equal 16 to 24 months pay a year. Others have yet to match salaries paid by commercial banks. Some units have introduced attractive incentive packages aimed at encouraging employees to seek out more deposits, increase loans and collections, value their jobs, and work more productively. Some banks provide adequate mobility support to their field personnel and are able to equip their key officers with cellular phones. Others are linked to their branches by radio or fax modem and plan eventually to link all outlets through modern automation.

### D3. Human Resource Development

Only a few rural banks systematically plan human resource development training programs for their staff and officers. They participate actively, however, in training programs made available by the Land Bank, the Central Bank, other commercial banks, the Agricultural Credit Policy Council, and the Rural Bankers Association of the Philippines. Lately, government-sponsored training programs in new financial technologies for servicing the lowest socioeconomic groups have also been available to rural banks. Some units have adopted these technologies as pilot projects. A few that have realized the importance of upgrading staff competencies are willing to pay for staff training.

Are available training programs adequate? The answer, in general, is no. The Central Bank still conducts the basic rural banking course for rural bank employees and officers. However, the system's pressing needs call for training in more modern banking techniques, including procedures for internal control, the proper design and pricing of financial products, cash management, and other skills needed for survival in what has become a level playing field. The Central Bank, unfortunately, is not filling this need. Rural bankers find that the Land Bank provides more adequate courses but offers them on an ad-hoc basis. Notwithstanding these sporadic efforts and those of the Rural Bankers Association, there is general recognition that a holistic and systematic approach to the training of rural bankers and their staff is needed.

#### D4. Planning and Operations

Most rural banks have yet to undertake regular corporate planning to improve their operations. As a matter of habit and reflex, many still passively adopt the Bank Plan and Budget that the Central Bank requires as a prerequisite for rediscounting with the monetary authority. But this tool is insufficient and impractical for charting a strategy to successfully meet the challenges of markets that are rapidly becoming fiercely competitive.

With a handful of exceptions, the positive changes taking place reflect the savvy of particular managers and owners rather than rigorous corporate planning. Since branching out has become a key strategy to consolidate gains and increase market shares, the need for rational planning will become more apparent. Such an approach will also enhance the process of mergers that is slowly emerging. At present, six rural banks have resulted from the merger and/or consolidation of a total of 46 previous unit rural banks.

A few rural banks have fully automated their operations. Automation has reduced the labor intensiveness of their procedures, reducing explicit transaction costs and improving the quality of service to clients. On the other hand, many units are partially automated, and a minority, especially those located in areas of unstable power supply, are not automated, with manual typewriters as their most modern equipment. Lead banking is the trend among CRBs in the Mindanao region, with the strongest becoming a source of financial and technical assistance to help the weaker ones.

#### E. Analysis of Financial Performance

How strong has the rural banking system become? According to a classification prepared by the Central Bank, the system has made an impressive turnaround since 1986, as can be discerned from Table 8.<sup>27</sup>

Table 8. Distribution of Rural Banks, by Comparative Level of Strength, 1986 and 1994

1986 (874 Unit Rural Banks)		1994*/(789 Unit Rural Banks)	
Classification	Percent Distribution	Classification	Percent Distribution
Strong	20	Operate Normally	68
Average	20	Need Preferential	
Weak	60	Attention	30
Total	100	Can't Classify	2
		Total	100

\*Classification of rural banks for 1994 based on supervision examinations conducted by the Central Bank at various periods during 1993 and 1994.

<sup>27</sup>In an interview with one of the authors in January 1996, a responsible officer of the Central Bank revealed that only 30 units, or 4 percent of the 790 units operating in January 1996, have serious problems.

## E1. Outreach

Rural bank offices, which numbered 1,274 at the end of 1994, represent one-fourth of total banking offices in the country (Table 9). By 1995, the number of rural bank outlets had increased to 1,348, including 790 unit banks (six more than in 1994) and 558 branches.

Compared with the heyday of the M99 period, the rural banking system has become leaner in terms of authorized units, but the number of branches has increased, doubling since 1990. In the past five years, the number of outlets has increased at an average annual rate of 5.71 percent. More than half these outlets are in Luzon (Table 10). The system's outlets are estimated to service about 500,000 loan accounts, and between 1 million and 1.5 million deposit accounts. At the end of 1994, the average loan and deposit accounts were approximately P19,200 (US\$740) and P13,000 respectively, far below the average account size of commercial banks. In the same year, the share of assets, loans, and deposits constituted a small fraction of national totals: 2.20 percent, 2.63 percent, and 2.16 percent respectively.

Table 9. Selected Indicators, by Type of Bank, 1994  
(Amounts in Billion Pesos)

	Assets (A)	Loans (B)	Deposits (C)	Ratio C/A(D)	No. of Offices	Deposit Per No. Office (P Mil)	Ratio Deposit to Loan
Commer- cial Banks	966.36	535.88	661.02	0.68	2,776	238.12	1.23
Thrift Banks	103.98	63.67	63.48	0.61	821	77.31	0.99
Rural Banks	27.65	18.60	17.45	0.63	1,274	13.69	0.94
Special- ized Govern- ment Banks*	157.03	89.30	65.18	0.42	217	300.35	0.73
Total	1255.02	707.45	807.13	0.676	5,088	158.63	1.14
Rural banks as percent to total	2.20	2.63	2.16		25.04		

Source: Central Bank Financial Fact Book, various years.

Table 10. Number of Rural Banks, Head Offices, and Branches by Region, 1994

Region	Head Office	Branches	Total	Percent Share
Luzon	461	353	814	64
Visayas	173	87	260	20
Mindanao	150	50	200	16
Philippines	784	490	1274	100

Source: Central Bank.



## E2. Performance<sup>28</sup>

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<sup>28</sup>The reader must take into account a very important caveat: the data is sourced by the Central Bank's consolidated balance sheets and statements of revenues and expenses whose accuracy, especially for the 1980s, is suspect. In fact, there is strong reason to believe that many units were allowed to keep current large unpaid loan balances in this period. This is a finding supported by the joint study of The World Bank and the Philippine Deposit Insurance Corporation. The consolidated data does show steep declines in total resources and net worth but in no single year of the decade do consolidated statements of revenues and expenses show a net loss. It is quite plausible, consequently, that assets, capital accounts, and revenues were overstated, and losses understated in the period. In addition, the consolidated data as reported by the Central Bank is the source of important distortions, in the sense that a handful of large, efficiently run units may have had a disproportionate impact on the overall profit and loss statements and, consequently, on the system's net income. All these factors, in combination with the fact that the consolidated data does not capture the financial impact of the transfers made available by the rehabilitation packages, make the adoption of a healthy degree of skepticism all the more desirable.

For all these reasons, a rigorous analysis of financial performance of the rural banking system is unfortunately beyond the scope of this study. Yet, this important methodological constraint does not invalidate one of the main findings of the study: that the rural banking system is on its way to healthy recovery. This conclusion is supported by four factors. First, while it is true that the accuracy of the consolidated data is probably unreliable, the trend of total assets, deposits, capital, and net income, especially since 1991, is not. In all, it is unmistakably positive. Second, in light of the successive rehabilitation packages launched in the late 1980's, the Central Bank has become more strict about financial reporting. Third, since 1991 the government has not launched more rehabilitation packages. Fourth, the authors of this study undertook a random revision of the financial statements of some units and concluded that they accurately reflected strong financial performance.

Financial indicators show an energized system that has grown at an increasing pace since 1992. In all, the system gives evidence of more diverse and selective loan portfolios, increased owners' paid-up capital, expanded deposits, and larger profits. Given the total system assets of a little more than US\$1 billion, private capital worth US\$91 million from about 7,850 owners,<sup>29</sup> and a workforce of some 12,740, the system's ability to generate half a million loan accounts and between 1 million and 1.5 million deposit accounts has been admirable.

Assets. The beating the system received in the mid-1980s due to high inflation and ill-conceived government policies that led to the closures of several banks is reflected in Table 11. Moderate growth resumed during 1986-89, a period that corresponds to the start of financial policy reform. High inflation again eroded any nominal gains in 1990 and 1991 but, real growth has steadily risen since 1992, as Table 11 also reflects.

Loans are the most important component of assets. Since 1991 the share of loans on total assets has hovered around 70 percent, well below the ratio that prevailed from 1980 to 1984. (Table 12). Besides the steep decline in the volume of loans sustained in the mid-1980s, a lower loan/asset ratio in recent years can be attributed to the adoption by the best units of more conservative credit analysis techniques, and also to the fact that a greater emphasis has been placed on savings mobilization than on lending. As regards the structure of the loan portfolio, rural banks have not abandoned farm financing. They have merely reduced their exposure to agriculture and significantly diversified their loan portfolios to provide more credit to commercial and industrial concerns as well as to salaried employees, public market vendors, operators of small public transport units such as tricycles and pedicabs, small businesses, and others. These borrowers have been grouped under the category of Other Loans (Table 13). Banks have become more selective, too, and many now require collateral or substitute collaterals because of bad experiences with unsecured credit under previous government programs. Salaried loans have become very attractive because banks can collect directly from payroll deductions.

Table 11. Rural Banking System Assets, 1981-1994, Nominal and Real Terms  
(in Million Pesos)

Year	Nominal Assets		Real Assets (1988=100)	
	Value	percent Growth Rate	Value	percent Growth Rate
1981	6490	18	15058	
1982	7978	23	17047	13
1983	9324	17	18913	11
1984	8819	(5.4)	12164	(36)
1985	8601	(2.5)	9610	(21)
1986	9104	6	10218	6
1987	9676	6	10540	3
1988	10693	11	10693	1

<sup>29</sup> Assuming an average of 10 owners per rural bank, as estimated by officials of the Supervision and Examination Sector for Rural Banks of the Central Bank.

1989	12160	14	10838	1
1990	13448	11	10498	(3)
1991	15489	15	10190	(3)
1992	18165	17	10969	8
1993	22157	22	12434	13
1994	27652	25	14232	14

Source: Central Bank

Loan portfolios are mostly short term. About half of reported loans are agricultural, but some are merely booked as such to qualify for rediscounting with the Central Bank or the Land Bank, entities that rediscount only agricultural loans. This fact, and the fact that violations of the Agri-Agra Law are inevitable, suggest that loans to the agricultural sector may be over-reported.

The adoption of more strict customer screening procedures as well as more rigorous loan management have resulted in better recovery performance. In the mid-1980s past-due loans reached as high as 43 percent of the loan portfolio. In 1994 this ratio had declined to 18.2 percent, well below the statutory ceiling of 25 percent imposed by the Central Bank. But much progress has yet to be made in this area. An overall ratio of 18 percent for the entire system does not compare favorably with the single loan default digit ratios that characterize the performances of the Bank Rakyat Indonesia and Thailand's BAAC.

Deposits. Gathering deposits is the most important skill the rural banks have acquired, or regained, after more than a decade of depending on Central Bank funds. From 1981 to 1994, real deposits almost doubled, with most of the growth occurring in the last three years of the period (Table 12). In addition, the ratio of deposits to assets of rural banks has risen steadily since 1986, compared to a flat trend for commercial and thrift banks.

Table 12. Real Growth Rate of Loans and Deposits and Loan Asset Ratio  
(Percentage)

Year	Loans	Deposit	Loan-Asset Ratio
1980	-4.4	-8.5	84.9
1981	-0.7	2.6	84.5
1982	12.1	15.4	83.6
1983	9.0	15.4	82.0
1984	-38.0	-37.7	79.6
1985	-23.8	-14.7	77.2
1986	2.5	25.3	74.6
1987	3.0	16.4	74.7
1988	1.1	6.1	72.5
1989	-0.9	5.9	72.9
1990	-4.1	-1.1	72.4
1991	-6.7	2.2	69.4
1992	13.2	13.5	69.8
1993	10.0	18.0	70.2
1994	13.5	20.0	69.2

Source: Central Bank

Table 13. Number and Distribution of Loans Granted by Sector, Years 1980 and 1994

Sector	1980		1994		1994/80
	Number	Percent Share	Number	Percent Share	Number Ratio
Agricultural	824,593	89.3	236,406	47.5	0.29
Commercial	62,383	6.8	80,557	16.2	1.29
Industrial	10,835	1.2	13,499	2.7	1.25
Other Loans	25,418	2.7	167,501	33.6	6.59
Total	923,229	100.0	497,963	100.0	0.54

Source: Central Bank

Most important, the ratio of deposits to loans has increased from 36 percent in 1980 to 91 percent in 1994 (Table 14). The rest of the banking system has a ratio close to or exceeding 1:1. Equally significant is the fact that the structure of deposit liabilities has been shifting from savings to time deposits, by all accounts a sign of growing public confidence in the system. It also means, however, that funds are now more expensive. Meanwhile, demand deposits are negligible, because only a few rural banks have been authorized to service current accounts. More rural banks are expected to apply for the authority to service current accounts in response to growing demand from their clients.

Table 14. Ratio of Deposits to (Gross) Loans and Structure of Rural Bank Deposits, 1980 to 1994 (in Percent)

Year	Ratio Deposits to Loans (gross)	Percent to Total Deposits	
		Savings	Time
1980	36.2	73.3	25.8
1985	45.5	65.2	34.3
1990	71.9	66.9	32.5
1991	79.0	64.1	35.4
1992	82.6	60.0	39.5
1993	85.8	56.3	43.3
1994	91.2	54.5	44.4

Source: Central Bank

Rural banks have designed their financial products to match the requirements of their markets. They generally service small savers. To open and maintain a savings deposit account, most rural banks require only P100 to P200 from customers, while the minimum required for time deposits is usually P1,000. Bank deposits that do not exceed P100,000 are covered by the deposit insurance program of the Philippine Deposit Insurance Corporation, a government entity. In general, rural banks pay higher interest rates on deposits than commercial banks, out of tradition as well as to attract local residents. Some rural banks undertake lotteries to attract more savers and many, particularly in Mindanao, offer “pick-up deposit schemes” that bring convenience services to the saver's doorstep. Pick-up schemes succeed in scooping up even the smallest amount of savings, often in public markets, commercial centers, or places where people congregate daily, such as fish landing wharves, schools, offices, and plantations. Interestingly, in areas with more than one or two rural banks, each bank finds its own deposit market for pick-up services (see Box 10). Although pick-up deposit schemes have possible risks, the regulatory authorities look favorably on this creative way of gathering deposits because it helps expand the system's deposit base and encourages small savers to use banks.

Rural banks mobilize savings and invest these in the local communities. In contrast, commercial banks gather deposits from the countryside and invest them in the big urban centers, despite government provisions to deter these actions. Because of their inherent characteristics, rural banks are effective vehicles for mobilizing local resources and keeping them in rural communities. Their market advantage does not reside in urban centers; in fact, their relative



ignorance of these large markets is inversely related to their intimate knowledge of the rural locale, which enables them to size up good lending opportunities in the countryside. Furthermore, for some units, mitigating the flow of financial resources from their territories is a call of the highest order, to be explained only by their close cultural identification with their own communities.<sup>30</sup>

Box 10. "Pick-up Deposit" Scheme and Market Niches

Pick-up deposit schemes. The Cooperative Rural Bank of BKD employs a savings solicitor, a bonded regular employee of the bank, to gather daily savings from 150 depositors in the public market, the bus terminal, and nearby small business establishments. He has solicited deposits there for more than five years, starting with fewer than 30 clients. He solicits savings in the afternoon, from Monday to Friday. His clients in the public market include vegetable vendors, fish and meat retailers, and small variety store owners. At the bus terminal, his depositing clients are small kiosk operators. At the periphery of the market he services the owners and employees of larger business establishments that include a pharmacy, an agro-chemical store, a doctor's clinic, and a dry goods store. Most have daily deposits of P100, a few more than P1,000, and some as little as P10 to P25. In some shops, he gathers deposits from three to four daily savers.

His procedures are simple. A set of provisional receipts, a ballpoint pen, and signature cards are all he usually needs. On the provisional receipt, he writes out the depositor's name and the date and amount of deposit; after signing, he tears out a copy for the depositor. He then moves to the next stall. All the deposits are in regular savings accounts earning 7.5 percent per year. "My clients tell me they are ashamed to go to the bank if they have only P100 to deposit," he says. "So, we come every day to pick up what they can afford to save regularly. They also want to be able to withdraw their deposits any time they need them. So we do not have limits on the number of withdrawals they can make. But there are hardly any withdrawals during the year. Withdrawals usually happen in December because of the Christmas season." The only time the depositors come to the bank is when they withdraw from their accounts. Their deposits are posted in their passbooks, which are kept in the bank for safekeeping, as the clients prefer. After an hour, the savings solicitor has gathered P25,555 from 41 savers. Some of this amount corresponds to the payment of the amortization of a few loans. Around 30 depositors have become borrowers of BKD and amortize their loans daily, weekly, or monthly.

Deposit market niches. At least 42 banks operate in the commercial center of the booming city of General Santos in Mindanao. Seven of the banks are rural banks. They implement their own deposit pick-up schemes in their specific market niches. For instance, Rural Bank of S has a solicitor who picks up deposits daily at the fish landing, where tons of tunafish are traded every day. There, the solicitor collects savings from the economic agents and cargadores. Rural Bank of T's pick-up service is only for employees of specific firms, while a branch of a cooperative bank solicits deposits daily in the city's public market and from businesses in the commercial center.

Capital. In real terms, the value of owners' paid-up equity and total capital accounts at the end of 1994 approached that of 1982. This is vivid testimony to the stagnation that permeated the system

<sup>30</sup>*"Pera ng Mindanao, Para sa Mindanao,"* the mission and slogan of Rural Bank NB, literally means: "The money from Mindanao is for Mindanao." Another rural bank's slogan is "Sa Taga Dito Na," implying: "Let people's savings be used by the people of this place."

in the 1980s. The trend has reversed, especially from 1992 to 1994, when both total capital accounts and paid-up capital posted substantial increases (Table 15). The four most important explanations for this change are as follows:

- First, a capital increase was a ticket to the benefits enshrined in the rehabilitation programs enacted in the late 1980s and early 1990s.
- Second, authorities served notice that the statutory minimum capital adequacy ratio of 10 percent would be strictly enforced; hence, no drive to significantly expand deposits would be permissible with a small capital base.
- Third, higher capital was necessary to finance the establishment of new branches.
- Fourth, additional high-quality services to clients, like checking accounts, are facilitated by more capital.

Table 15. Capital Build-up: Trends, Selected Years 1981-1994, in Real Values (1988=100)  
(Amounts in Million Pesos)

Year	Total Capital Account		Paid-up Capital	
	Amount	Percent Increase	Amount	Percent Increase
1981	2051		1394	
1985	1521	-25.8*	1134	-18.7*
1989	1728	13.6	1227	8.2
1990	1779	3.0	1227	0.0
1991	1759	-1.0	1179	-4.0
1992	1938	10.2	1335	13.2
1993	2185	12.7	1467	9.9
1994	2355	7.8	1537	4.8

\*Percent increase from 1981.

Source: Central Bank, from basic data.

In 1995 the Central Bank passed a resolution requiring rural banks to increase their paid-up capital. This measure will further strengthen the health of the entire system. As regards government match-up capital funds, preferred shares comprise 20.6 percent of the system's total paid-up capital. Interestingly, although the bulk of the preferred capital is held by government banks, some rural banks, including CRBs, have begun marketing preferred shares to private investors. This is the approach Davao Cooperative Bank and CRB Aklan have taken recently to expand their capital base, with clear signs of success.

### E3. Revenues, Costs, Profitability



Table 16 portrays ratios of income and expense to average assets for commercial banks, private development banks, and rural banks in 1994. According to the data, the rural banks fared relatively well compared to the other two types of entities. Significantly, income from lending has risen considerably from the 9 to 10 percent range that prevailed in the 1980s, and now constitutes the bulk of gross income.

Table 16. Ratios of Income and Expense to Average Assets  
by Type of Banks, 1994 (in Percent)

	Regular Commercial Banks	Private Development Banks	Rural Banks
Interest income	7.98	13.91	14.5
Other income	1.51	2.40	1.2
Gross operating income	9.49	16.31	16.7
Interest expense	4.30	8.38	6.2
Salary & personnel expenses	1.77	2.23	4.3
Other admin expenses	3.30	3.57	3.8
Gross operating. expense	9.38	14.19	14.3
Net operating income	0.11	2.11	2.4
Extraordinary credits	0.97	0.54	--
Net income bef. taxes	1.08	2.65	2.4

Source of basic data: Central Bank, Financial Fact Book, 1994.

Interest expense has also risen from between 4 percent and 5.5 percent in the 1980s to 6 percent and above because rural banks are depending more on internally generated resources and pay competitive rates on deposits. Salary and personnel expenses have also increased, probably reflecting adjustments in staff incentive packages to more competitive levels.

Focusing on the profitability of lending by rural banks, it is interesting to note from Table 17 that loan administration costs, i.e., the explicit transaction costs of lending, declined considerably in 1994 to 8.7 percent from the 12 plus percent that prevailed 1991 to 1993. This suggests that the rural banks have become leaner and more efficient, probably in response to greater competition. However, there is much room for improvement in this area. As compared to the lending costs of BAAC and BRI, the Philippine system's loan costs are still way too high. Table 17 also shows that the income from loans and the financial costs of lending have doubled since the early 1980s. Most banks charge interest rates of between 18 percent and 22 percent per year, which are usually flat rates, while add-ons for service and other fees (usually including life cum loan insurance) are between 4 percent and 8 percent per transaction.<sup>31</sup> Financial costs have risen as rural banks strive to mobilize more deposits and capture more time deposits. Although time deposits are more costly, the fact that rural banks are progressively mobilizing this type of savings indicates a higher level of sophistication among rural depositors and an improved technical knowhow on the part of rural banks. It may also reflect the likelihood that the image of rural banks has improved over the last few years.

<sup>31</sup>With some exceptions, rural banks follow somewhat simplistic pricing practices. The common practice is to find out what other banks in the area are charging rather than going through an in-depth study of their own cost structure. Moreover, rural banks hardly distinguish loan pricing by type of product, nor by whether a loan is secured or not.



Table 17. Lending Income, Expenses and Spread, 1981 to 1994,  
(in Percent of Average Loan Portfolio)

Percent to Average Loans Outstanding									
Year	Amount Avg. LO*/ (Pesos mil.) (A)	Inc. from Loans (B)	Finan. Expn. (C)	Gross Spread (D=B-C)	Salary & Benefits (E)	Other Expenses* * (F)	Total Admin. Cost (G=E+F)	Case I Net Spread (H=D-G)	Case II Net Spread (I)***
1981	4960	11.5	4.9	6.6	3.5	2.9	6.4	0.2	1.2
1982	5928	11.5	5.6	5.9	3.3	2.8	6.1	-0.2	0.7
1983	6991	11.7	6.2	5.5	3.1	2.8	5.9	-0.4	1.1
1984	7145	12.6	6.3	6.3	2.4	3.4	5.8	0.5	1.4
1985	6617	14.0	7.1	6.9	4.4	4.3	8.7	-1.8	-0.5
1986	6480	14.9	7.2	7.7	4.4	3.8	8.2	-1.0	0.7
1987	6743	15.5	6.3	9.2	4.8	4.2	9.0	0.2	1.6
1988	7294	15.4	5.8	9.6	5.3	4.4	9.7	-0.1	1.4
1989	8071	17.3	6.3	11.0	5.9	4.8	10.7	0.3	1.9
1990	8900	16.2	5.9	10.3	5.0	4.3	9.3	1.0	2.4
1991	9800	20.9	8.9	12.0	7.0	5.7	12.7	-0.7	1.2
1992	11498	20.5	9.1	11.4	6.8	5.4	12.2	-0.8	1.0
1993	13866	21.4	9.1	12.3	6.5	5.5	12.0	0.3	2.1
1994	16814	21.4	9.2	12.2	6.4	2.3	8.7	3.5	4.8

\*Average of beginning and ending year figure.

\*\*Includes expenses for mobilizing funds, bad debt, and corporate income tax.

\*\*\*Assumes expenses for lending is less 15 percent attributable to expenses for non-lending activities.

The higher rates rural banks pay on deposits are neutralized by the lower cost of mobilizing funds. Based on empirical findings of Casuga's "Transaction Costs Under an Agrarian Reform Regime," the transaction cost per deposit account of rural banks averaged P112.23 while the average for private commercial banks was P253.34.<sup>32</sup> Per peso of deposits, however, rural banks and commercial banks incurred almost the same cost, at P0.07 per peso of deposit because of the bigger amounts of deposits of commercial banks compared with that of rural banks. The study also found that of the total transaction cost incurred by the seven sample rural banks, funds mobilization cost comprised 27.6 percent, compared to 48.6 percent for two branches of private commercial banks.

As regards lending costs, empirical studies likewise reveal the cost advantage of small, locally based rural banks. Untalan and Cuevas (1988) found that the total transaction cost was P473 per loan

<sup>32</sup>In Llanto and Dingcong, ed. (1994). Funds mobilization costs were estimated for two private commercial banks, six rural banks, and two state government banks. These included costs of transactions with depositors and clients (new accounts, deposits), record keeping and withdrawal, and advertising and promotion specific to deposit taking. The lending costs of banks were estimated from the time allocations for different activities, the schedules of salaries of personnel, and financial statements of sample banks.

account outstanding for rural banks, compared to P14,500 for commercial banks and P1,839 for private development banks. Using the same methodology employed by Untalan and Cuevas, Casuga, using smaller sample banks, similarly found a lower transaction cost per loan account granted by rural banks (average of P1,240), compared to the average of P3,433 for branches of private commercial banks. Again, because of bigger loan amounts, per peso transaction cost is lower for commercial banks as seen in Table 18 below.

Table 18. Comparative Lending Transaction Costs (TC), by Type of Bank, Average Per Sample Bank, (1989-1990, in Pesos)

Type of bank Number of sample branches/units	PKBs(2)	RBs(7)	SGBs(3)
1. Lending TC Per Loan Account Granted (in Pesos)	3,433	1,240	14,019
2. Lending TC Per Peso Loan Granted	0.023	0.095	0.187
3. Lending TC Per Peso Loan Outstanding	0.030	0.078	0.064
4. Avg. Outstanding Loans, June 1990 (PMil)	29.1	9.3	30.8

Source: Magdalena Casuga, "Transaction Costs Under An Agrarian Reform Regime," in Llanto and Dingcong, eds. (1994).

That rural banks are at a distinct advantage for providing microfinance services in the countryside is evident in the lower overhead and cost of information gathering they incur. If commercial banks were to handle the same types and volume of deposits and loans that rural banks do, given the former's cost configuration, their transaction costs would be as much as 30 centavos per peso of deposit mobilized, way above the seven centavos that rural banks incur, and P0.094 per peso of loan outstanding, which also compares unfavorably with the P0.078 estimated for rural banks. Local information access and lower transaction costs are the virtues of rural banking. It is because of these, too, that the remaining challenge to make the system stronger and more efficient becomes critical. The recent past has demonstrated concretely that small unit banks extending financial services in the rural areas have more than a fair chance of surviving under more friendly and positive environment. Whether the system will continue on a sustainable growth path will depend on a number of factors and the ability of the system to overcome major challenges.

#### F. The Challenge Ahead

Although the unreliability of the consolidated data precludes this study from a more thorough analysis of financial performance, extensive field interviews with rural bankers, the careful examination of some units, and a general atmosphere of confidence that has swept the industry suggest that, since 1992, a healthy recovery of the entire rural banking system is under way. A growing economy, a more liberalized financial policy regime, and the emergence of more capable bank owners and managers are all factors in this remarkable turnaround. After displaying exceptional resilience in times of crisis, is the Philippines rural banking industry sure to grow by leaps and bounds in the years ahead? If so, rural bankers must successfully meet the challenges of a more competitive economic environment, and policy makers must take decisive steps to ensure financial stability. A brief discussion of some important concerns follows.

Increase deposits. First, despite the fact that deposits have been growing steadily in recent years, much remains to be done in this critical area. As of December 1995, the ratio of deposits to loans for the entire system was still below 1, comparing unfavorably with the 1:1 and 2:1 ratios featured by urban-based commercial banks and the Bank Rakyat Indonesia, respectively. Without further improvement in capturing rural deposits, the present growth rates in lending and capitalization cannot be maintained, because the system will remain dependent on outside funds for its survival.

In recent years, the country has benefited from rapid economic growth in combination with low inflation. This paves the way for improved performance in financial savings nationwide. A key challenge for rural banks in particular is to develop cheaper and longer-term deposit instruments. This is critically important in enabling rural banks to offer the lower-cost, longer-term loans needed to respond successfully to more intense competition. They cannot do so at present, because their structure of loanable funds is loaded with short-term instruments.

Discontinue harmful subsidies. Past lackadaisical efforts to mobilize deposits can be traced to the legacy of so many years of easy access to rediscount credit lines offered by the Central Bank and government banks. The terms of rediscount are stiffer than in the past, but there remains a lack of coherence and direction in this important policy. There are still 111 government-directed credit programs, some of which are offered to financial intermediaries at subsidized rates or even zero interest. The large number of these programs, and the keen competition to access them, result in glaring inefficiencies, including the targeting of the same beneficiaries by different programs. Equally significant is that many of these programs are poorly administered, not only by financial intermediaries but also by the government agencies and nongovernment organizations. These organizations generally have a poor record in credit administration, and their lack of zeal in collecting loans undermines the microentrepreneur's chances for a more expedient entry into the formal financial market.

A major provider of rediscount lines is the Land Bank. This entity wholesales funds at a rate determined by short-term treasury bills that is normally higher than that offered by the Central Bank. At the same time, the Land Bank retails funds to final users, which brings it into direct competition with rural banks. The policy is clearly contradictory and the object of bitter complaints by some units.

Under ideal circumstances, the Central Bank should concentrate on conducting monetary policy and let a well-run development bank wholesale long-term funds and provide equity financing. In the Philippines, the Land Bank does provide equity financing, but the implicit danger is that its wholesale and retail credit operations may be pouring too much money into the system and slowing the growth of deposits in rural areas. Although there is evidence that the Land Bank now finds fewer takers of rediscount lines than in the past, many rural banks still find it convenient to access these sources of funds. For several rural banks, campaigns to capture deposits do not seem to be high priority.

Another danger is that the weaker units may collude and exert political pressure to extract concessional rates, extended repayment periods, more bail-out packages, or even outright debt condonations from the Central Bank and the Land Bank. This is a distinct possibility in any country where recurring measures of this kind may imprint in the memories of bankers the idea that the old rules of the game are there to stay. In the case of the Philippines, the bail-out packages were justified by the hardships inflicted by misguided government policies. Now that the policy regime has

changed for the better, more government assistance in the form of unjustified subsidies should be firmly resisted.

Continue policy reform. Liberalizing interest rates, lifting the ban to license new rural banks, removing monopoly/franchise rights in towns and municipalities, and increasing the Central Bank's minimum paid-up capital requirement are helping revitalize the rural banking system. Further financial policy reforms must be introduced, however, to sustain the process. An issue that requires particular attention is the temporary lifting, until 2002, of the 20 percent ceiling on voting stock that a family can invest or own in a rural bank. Not surprisingly, this suspension has encouraged owners to increase capital. But whether a family that holds more than 20 percent of stock must dilute its ownership after the ceiling is reestablished must be clarified.

As previously mentioned, credit quota policies are ineffective. Both the Agri-Agra Law and Magna Carta for Small Enterprises Law enable commercial banks to meet the quota requirement by buying equity positions in rural banks. This option must be encouraged for the positive externalities that such transactions generate. However, ownership linkages between commercial and rural banks are best engineered by market forces and not by government decrees that may ultimately raise the transaction costs for the parties involved.

Setting a lower reserve requirement for rural banks than for commercial banks does not result in tangible benefits for the former. Under these circumstances, commercial banks usually set up thrift banks to take advantage of the lower implicit taxation. A more important distortion is the deposit retention scheme that obligates banks to lend at least 75 percent of rural deposits in rural areas. If banks do not find good lending opportunities, they may be discouraged from capturing more deposits. In the end, depositors may be penalized and the drive to increase savings abandoned.

Improve rural bank supervision. There is an urgent need to enhance prudential supervision. The Central Bank has yet to install an effective off-site supervision system capable of providing an early warning of bank distress. It now has an inadequate procedure whereby the monthly financial reports required from rural banks are merely recorded in the Central Bank's supervisory unit as having been received. Without further evaluation, they are forwarded to the Supervisory Reports and Studies Office where the financial data is processed for future consolidated reports on the system. Therefore, the value of the information obtained for early problem detection and monitoring is nil.

The Central Bank's supervisory unit conducts an annual examination of rural banks. The audit team for each bank ranges from two to 10, depending on how many branches the bank has. The audit of a relatively big bank easily consumes three to four weeks of staff time. About 200 examiners have been assigned to supervise rural banks, an insufficient number to ensure adequate examination of the system. Feedback from the field is mixed on the manner in which the examinations are conducted, ranging from comments that the audit is carried out with the objective of finding fault or is not thorough, to the perception that the audit is efficient and constructive. Central Bank officials who view the examinations as inadequate attribute the inadequacy to having too few days to complete the task. This reality is related to scarce funding; no doubt in response to intense political pressure from rural bankers, the Rural Bank Law of 1992 substantially reduced the annual supervisory fee that rural banks pay.

Given the numerous units that compose the rural banking system, the incorporation of off-site supervision techniques can no longer be delayed. Such techniques will provide a higher degree of confidence in the stability of the entire system. There is also a need for automating supervisory

procedures. Central Bank supervisory staff still use manual typewriters, negatively affecting productivity and morale.

Finally, it must be noted that the Central Bank has been acting as both promoter and supervisor of the rural banking system. This arrangement is not suitable because it assigns the Central Bank two roles that may be in direct conflict with each other. Built-in political pressures favor promotion at any cost over supervision. When supervision is neglected, the consequences for the entire system may be catastrophic.

Address the competitive challenge from commercial banks. Economic growth and financial liberalization result in excellent prospects for expanding financial services, but they pose significant threats as well. A common practice among commercial banks has been to open branches in bigger towns adjacent to rural areas, primarily to capture deposits. The bulk of these funds are transferred to offices in Metro Manila, Metro Cebu, or Metro Davao for lending operations in these cities. The evidence is strong, however, that commercial banks may be expanding into rural lending, especially commercial banks that are finding it more difficult to keep their market share of traditional clients in urban areas. In fact, there are visible signs that some commercial banks are being forced to downscale and are intent on competing for loan accounts held by rural banks. This is a direct consequence of both stiffer competition among commercial banks and a revitalized rural economy. The trend poses a direct threat to rural banks that have established their niches in the upper segment of the market and whose main competitors have been entities of another league: pawnshops, lending investors, and other rural banks.

For such banks, trying times lie ahead. They may have been relying too complacently on the easy capture of huge rents, especially from a handful of large loan accounts. For example, among some bank branches operating in Laguna Province, it is not uncommon for approximately 10 percent of customers to account for more than 70 percent of the banks' loan portfolios. While the loan rates stand at 24 percent, the commercial banks have been moving in with rates of 12 percent. Customer loyalty to the high quality of personalized services offered by rural banks will not be enough to sustain the situation. Commercial banks are indeed poised to raid the bigger accounts and leave the rural banks with depleted assets.

Thus, the biggest challenge lies in deciding how to meet the threat posed by the downscaling operations of commercial banks. One option is for rural banks to fight it out with the commercial banks and strive to keep their market shares. To succeed, the rural banks must cut their explicit transaction costs to the bone. This may entail laying off staff as well as automating operations and introducing additional services to customers targeted by the competition. The disadvantage of this strategy is that commercial banks are more likely to succeed because of the larger financial resources they command. This unfortunate reality may drive rural bank managers to adopt short-term, desperate measures that are self-defeating in the long term.<sup>33</sup> Another option lies in redefining market niches. Endangered rural banks could effect a downscaling strategy of their own to find a lower-income market segment where they could exploit their cost and information advantages. But rural banks

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<sup>33</sup>For example, one branch manager, when questioned about her strategy to face commercial bank competition, replied that she was going to access rediscount credit lines from the Central Bank because these sources of funds are cheaper than deposits.



would probably resist this course of action because it would result in a lower average loan size and probably lower profit margins.

Aside from enticing commercial banks to buy equity positions in their units, rural banks stand a better chance of success against the urban-based “behemoths” if they intensify efforts to open more branches to attain higher economies of scale and lower operating costs. More important, rural banks must exhaust efforts to merge or consolidate, thus pooling resources to increase their financial wherewithal. Unfortunately, this is more easily said than done, not only because mergers take time but also because family-owned units normally resist this option. This is the best strategy, however, because it will enable rural banks not only to consolidate their market shares, but also to finance their expansion into lower market segments.



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### SECTION III

#### LESSONS OF THE PHILIPPINE EXPERIENCE

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A central proposition of this study is that the Philippine model contains the basic elements of a successful approach to the problems of rural microfinance. Further research into this rich experience is therefore of overriding importance. Moreover, a thorough, in-depth understanding of this model is necessary for another compelling reason: the Philippine experience of 40 years lays bare both the failures and successes of the design and execution of particular financial policies. It provides development practitioners and policy makers of other low-income countries with an invaluable rich prescription of what works and what does not: the “dos” and the “don’ts” of rural microfinance.

When the rural banking system was launched in 1952, its design did not follow the prescriptions of other models tested elsewhere. To the contrary, most low-income countries were either ignoring the problems of rural microfinance or promoting state banking to fill the demand for financial services left unmet by private commercial banks. Instead, the Philippines relied on ingenious government intervention to propel the creation of as many privately owned rural financial entities as possible. This approach, in combination with active government involvement in training rural bankers and in supervising and monitoring established concerns, makes the Philippines case an interesting if not unique model from which valuable lessons can be extracted for the benefit of other countries.

As this study graphically demonstrates, the Philippine rural banking system has endured times of deep crises since its inception. To a great degree, these crises were the result of misguided government policies. Recently, as the result of a more committed government drive toward financial liberalization, the rural banking system is showing signs of impressive vitality. The rehabilitation packages have no doubt played an important role in the recovery of the system. But this critical government support should not be viewed as proof that the sustainability of the system is linked to the availability of outside financial assistance. If anything, “too much” government money has been one of the most important factors leading to the debacle of so many entities in the past. The present recovery is related more to a growing economy and to the emergence of a new breed of highly capable bank owners and managers who must now contend with the inherent challenges of a more liberalized financial policy regime. To the extent that these two key trends continue, the need for further outside assistance will remain a remote possibility.

The recovery of the Philippine rural banking system is also intimately related to the distinctive features of the Philippine model. Some of these features have been modified through a painstaking learning process that, given the absence of similar undertakings elsewhere, had nowhere to turn but to the lessons of its own experience. Yet it is truly remarkable that the basic foundations of the model have remained unchanged. And because the model has led to a system of rural financial intermediation that shows signs of increasing strength, assessment of its applicability to other low-income countries is therefore pertinent.

#### A. Principles

The strength of the Philippine rural banking system lies in the application of simple principles. These principles are based on the assumption that neither downscaling by urban-based private commercial banks, nor the upgrading of financial entities that are “closer to the poor,” will be enough to bring an adequate supply of financial services to marginalized rural households and

microentrepreneurs. The impact of these undertakings is unfortunately limited and, therefore, thoroughly insufficient to propel a broadly based expansion of financial services to this clientele.

An integrated approach. The paradox of rural finance will remain unsolved as long as the great divide between formal and informal financial markets persists. The gap takes the form of a mismatch between the availability of financial resources and required information on customers. The first principle of the Philippine model takes stock of this reality: an adequate solution to the problem of rural microfinance requires the pooling of these two critical elements (resources and information). Yet, it argues that the solution lies not in enticing urban-based commercial banks to invest in information (downscaling), or in providing financial resources to the informal intermediaries that have the information (upgrading), but in establishing a holistic integrated approach to establishing banking systems in rural areas.

An institutional framework tailored to rural financial markets. A second principle follows. The primary goal of a successful approach to rural microfinance should not be to establish rural financial entities. These, it should be noted, are by-products of a more important goal: to develop rural banking systems. Meeting this goal requires the design of an integrated strategy whose purpose and priority must be to establish an adequate institutional framework on which the strength of the system will ultimately depend. The central elements of such an institutional framework—legal and accounting systems, prudential regulation, and supervision—already exist in most if not all low-income countries, but they are largely irrelevant because they are not tailored to the specific characteristics of rural financial markets. Therefore, financial transactions in rural areas are effected in an institutional vacuum that in practice denies rural financial markets the opportunity to prosper.

Private ownership. The third principle is of particular significance: if an appropriate institutional framework is put in place, the market will take care of developing the entire system. This development is propelled by tailor-made rural banks that have embraced a commercial approach to their operations. These banks, it must be underscored, are owned by regional entrepreneurs and/or community-based cooperatives, and have managers who live in and intimately know their communities and clientele. The approach therefore relies on the advantages of private capital ownership.

Simplicity. The fourth principle is simplicity. An amazing feature of this model is that it is relatively simple and uncomplicated to administer. Moreover, it is inexpensive. Beyond some start-up costs related to the design of specialized legislation and the processing of licences, the biggest expense is in creating a supervisory agency with full responsibility for monitoring rural banks. These costs must be compared with the substantial benefits to the country that adopting such a system will bring.

Selective and restricted government intervention. The fifth principle derives from the above and relates closely to the issue of government action. The public sector does indeed have a vital role to play in this approach. To be effective, however, public sector action must focus on the task of building the institutional framework in rural areas. It is important that such action be localized, precisely in the geographical areas where institutions are wanting. A critically important task is enacting special legislation to embrace the dual objective of fostering the creation of as many banks as possible and providing strict rules and procedures for compliance with prudential norms and supervision. Beyond these actions, interventions must take the form of non-price subsidies, for example, providing comprehensive technical assistance packages, and financing the training of rural bankers in banking techniques and the implementation of computer-based credit expansion and monitoring systems to accelerate the development of stable, expanding, and viable rural banks. In

addition, it makes sense for governments to consider tax write-offs for establishing new branches in strategic locations. Last but not least, the government can also intervene by taking equity positions in rural banks, which bolsters their capitalization.

These five principles—an integrated approach for establishing a banking system, an institutional framework tailored to rural markets, private ownership, simplicity, and selective and restricted government intervention—can be applied in many countries across regions, especially where financial markets are severely segmented and population growth in rural areas is triggering the development of secondary and tertiary cities. In such countries, the growth of these cities is likely to be accompanied by the decentralization of economic and political power. Consequently, both local governments and the nascent regional *bourgeoisies*, including a new breed of rural bankers, are expected to become much more active protagonists of development. This sets the stage for strengthening local government capabilities to raise the quality of public goods by reducing implicit transaction costs on the one hand and expanding and closely integrating regional markets on the other. The logical outgrowth of this process is a vastly larger critical mass of demand for financial services in these particular regions. This demand will best be met, not by NGOs or credit unions that find it hard to relinquish their social orientation, nor by large urban-based commercial banks focused on their traditional clientele, but by newly emerging banks owned by local entrepreneurs who have a stake in their regions and are willing to take advantage of incentives provided by an appropriate regulatory and institutional framework.

Are there low-income countries where these principles cannot be applied? Two probable cases can be cited. The first are countries with governments that may not possess the technical capabilities either to set up the system or to monitor it appropriately. This impediment is not insuperable, however, because it can be remedied with the help of international donors. In fact, both bilateral and multilateral donors are exceptionally well positioned to fund well designed, appropriate technical assistance programs with the purpose of transferring the system as a whole or some parts of its institutional components to other countries. The second case relates to countries that are not blessed, because of very low incomes, widespread risk aversion, or a legacy of stifling centrally planned policies, with the presence of a strong, regionally based entrepreneurial class. This would indeed be a serious impediment, because the model draws its strength from the dynamism of profit-seeking entrepreneurs who identify with and are cognizant of conditions of their own localities. Yet, in these times in which the fast globalization of markets and ideas exerts a powerful demonstration effect even in countries that still cling to some variants of an autocratic approach to development, this impediment may be more theoretical than real.

## B. Lessons

An extraordinarily attractive feature of the Philippine model is that it provides valuable lessons on the dos and the don'ts of rural microfinance. The most important of these are discussed below.

## B1. The Dos

### B1a. Lower Minimum Capitalization Requirement<sup>1</sup>

Consider the situation of Latin America, a region that has witnessed far-reaching change in recent years in financial policy reform. Several of these countries<sup>2</sup> have recently enacted bank legislation that includes a uniform minimum capitalization requirement. Unfortunately, this requirement too often reflects the relative political strength of existing private commercial banks. Therefore, such legislation ratifies “business as usual,” and ensures that the highly exclusionary financial landscape will remain unchanged. Under these circumstances, existing banks may open offices and branches in rural areas if economic conditions are attractive enough. But this measure will fall far short of increasing significantly the supply of financial services to rural microentrepreneurs.

The Philippines has followed a different approach. By virtue of specialized legislation, the Philippine model sets a lower minimum capital requirement for rural banks than for the large urban-based commercial banks. The critical assumption is that regionally based entrepreneurs and community-based organizations that are willing to set up rural banks are not as financially endowed as the large urban investors. More important, a lower minimum capital requirement must also reflect initial capital outlays that correspond to far smaller loan and savings accounts and less expensive facilities. A small clientele will be served only by banks with a smaller capital base.

The critical question is how small the minimum capital requirement should be. In principle, it should not be too low, because the temptation for new entrants to incur on moral hazard may be impossible to resist. Nor should it be set too high relative to the real financial possibilities of regional investors, for such a requirement would in practice become a barrier to entry. The final decision, in essence a balancing act between two unwelcome extremes, should reflect a careful analysis of particular situations. If the decision process is tainted by biases, it is preferable to err in the direction of higher, not lower minimum capital requirements, because the expansion of lending operations and the investments necessary to raise productivity levels are seriously impaired when the capital base is very small. In this regard, the experience of the Philippines is valuable. It offers persuasive evidence that the too-low minimum capital requirements imposed when the system was launched impinged on the very stability and strength of financial entities.

### B1b. Human Resource Development

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<sup>1</sup>To avoid confusion, the discussion that follows refers to the minimum paid-up capital as required by banking authorities, not the capital adequacy ratio. We surmise that this ratio should be set as high as, if not higher than, that applied to commercial banks given the risks associated with the inevitable learning process that accompanies the establishment of untested small rural banks.

<sup>2</sup>Honduras is the most recent example. In November 1995, the government passed a law stating a minimum capital of \$3 million for all banks.

The evidence that the best rural banks are those endowed with strong management teams is beyond doubt. In combination with an adequate capital base, a sound local economy, and an adequate financial policy environment, human resource development is a key variable in the success or failures of units. The best and largest family-owned and cooperative rural banks are committed to improving the skills and qualifications of their management teams, loan officers, and clerical personnel. These units invest heavily in such efforts and strive to bring state-of-the-art banking techniques to their personnel through training courses offered several times a year.

Education is an investment that raises the productivity of human capital. In the Philippines, the government was always committed to this principle, as evidenced by the banking seminars and on-the-job training courses that the Central Bank offers. While the principle must be upheld, perhaps it is advisable to change the vehicle for training. Training courses and seminars offered by the Central Bank make sense if this entity is not overstretched in its functions, so as to ensure the provision of high-quality services, and if this function does not conflict with the more important tasks of licensing, supervision, and monitoring. In interviews with rural bankers, as noted before, we detected some displeasure with the quality of the training, manifested in their preference for courses given by the Land Bank or by commercial banks. Therefore, it would be appropriate if the government reaffirms its commitment to human resource development by financing state-of-the-art seminars and training courses presented by outside experts, who could include local commercial bankers with unblemished reputations.

Such courses and seminars should, at a minimum, cover topics such as financial management reporting systems; cash and portfolio management; instruments and systems to capture deposits; accounting and internal control systems; loan and savings product development; and risk analysis. Equally important, such seminars could provide information on the most adequate and updated accounting and financial software packages. Their installation would help reduce explicit transaction costs significantly.

#### B1c. Government Participation in Capitalization

Government participation in the Philippines took the form of equity matching, i.e., the purchase by government banks of non-voting preferred shares. This was an excellent idea, because it contributed to a higher capitalization of rural banks without wresting control of operations from private owners and managers. The principle behind this arrangement is sound: the system should be led by the private sector and free of unhealthy government intervention. Unfortunately, as noted above, this did not happen in the Philippines, especially during the period of Masagana 99.

Why wasn't this principle upheld? The answer to this question provides useful insights into the political economy of rural finance in the Philippines. On paper an equity position on the part of the public sector was restricted to capitalization, but in practice the government exercised undue influence on portfolio decisions. This was made possible by the particular relationship that evolved between the government and the private rural banks. The government showered rural banks with overly generous subsidies and incentives. For example, the yield on the non-voting preferred shares was just 3 percent. In addition, as depicted in Table 1, rural banks were exempted from the payment of all taxes. While the avowed intentions of these measures was to foster the development of rural finance, in practice they were bribes that opened windows for government interference.

The logical consequence was the addiction of rural banks to these privileges and an utter dependence on the whims of government authorities to enforce them. In fact, the banks became hostage to the government—not the other way around—because, unlike several countries in Africa

and Latin America, the government in the Philippines has traditionally managed to maintain a semblance of relative autonomy vis-à-vis the intruding influence of powerful economic groups with vested interests. In any event, the rural bankers were never powerful enough to engage in a protracted fight to keep these perks for themselves, most of which defied the principles of sound finance and development practices.

#### B1d. The Creation of a Specialized Agency in Rural Banking

The creation in the Central Bank of a department to supervise rural banks signaled the government's commitment to foster the development of a rural banking system. Unfortunately, critical functions—policy development, licensing, credit program administration, training, supervision, and monitoring—were housed in and executed by the same department. Later, this department was stripped of personnel, endangering its capability to perform its supervisory function adequately.

Other low-income countries can benefit immensely from the costly policy mistakes that were committed in the otherwise excellent design of the Philippine rural banking system. But this does not invalidate the proposition that the creation of a specialized government agency with the sole responsibility of overseeing a rural banking system is a sound idea. This agency can probably be housed with the prudential supervisory agency of the country but enjoy full autonomy and enforcement powers to intervene with entities that do not comply with prudential norms and regulations.

#### B1e. Rehabilitation Packages

Bailing out banks is a risky endeavor not only because of the costs involved, but also because it sends the wrong signals to the financial community. It is a measure that undermines the discipline that the market should be able to enforce among participants. Given the particular circumstances of the time, however, the government was fortunately prescient in offering the rehabilitation packages. Aside from the fact that the government's responsibility in triggering the banking crisis was clear for all to see, and that it had virtually no other option given the rule of an implicit deposit insurance scheme, it is possible to ascertain that, with the benefit of hindsight, the majority of rural banks would probably have collapsed without the packages. This scenario would have deprived the country of the tangible and substantial benefits generated by the present recovery. The costs of the system's collapse would definitely have been higher than those incurred by the bail outs.

The challenge now consists of holding firm to the new rules of the game and in strengthening the existing explicit deposit insurance scheme. Given the present economic environment, rehabilitation packages are no longer warranted, despite pressure from some units to provide them. It would be best for government authorities to let the most inefficient units go under or promote their acquisition by stronger banks. Doing so would send the signal that risky and irresponsible behavior on the part of bankers can be undertaken only at their own risk.

#### B2. The Don'ts

##### B2a. Cheap Rediscounts

As stated in last section, the government prodded rural banks to access rediscount credit lines from the Central Bank to ensure adequate financing of Masagana 99. Essentially a tool to channel targeted and subsidized credit to a selected activity, this was probably the worst decision made by the



government authorities, a clear example of pervasive meddling and misguided financial policy. For several years, these credit lines were offered very cheaply, and their administration was fraught with inefficiencies and fraud. In fact, what evolved was a system prone to abuse. During the heyday of Masagana, it was not uncommon for rural bankers to leverage as many as 20 times their own equity—with public funds. Neither was it infrequent for units to engage in massive inside lending, made possible either by circumstantial oversights of the Central Bank supervisory agency, or by the perception that the government would ultimately step in to bail out banks and remedy an unhealthy situation largely of its own making.

The government did in fact step in and decided to let the ax fall where it might. Most of the 300 rural banks that were closed were punished for abuses they committed. But the government also stepped in to help rescue the rest, a tacit acknowledgment of its responsibility for the poor policies inflicted on the system. Today, however, several rural banks are still in arrears with the Central Bank, a symptom more of internal, rather than exogenous, problems.

The adverse consequences extended far beyond these problems. A very important casualty was the learning process, so vital for the improvement of banking practices, because many rural banks unfortunately preferred the coziness inherent in the role of loan conduits to the challenges of becoming autonomous, authentic financial intermediaries. Intimately related to this point is that many banks dismissed all efforts to mobilize savings. This shortsightedness would prove costly, as the painful events of the 1980s subsequently demonstrated. Given that the government threw its weight behind the campaign to entice banks into joining the program, it may be argued that the banks had no other choice. Yet, it is remarkable that a good number of banks were not swayed by the lure of short-term gains and thus turned a cold shoulder on the entire program. Managers of these units definitely counted on foresight and caution, attributes that, it must be underscored, constitute the foundations of an appropriately conservative, albeit solid approach to bank management.

Is it possible to rescue a positive element in rediscovers? Probably only in the fact that rural banks in the Philippines were afforded the same privileges as the large private commercial banks. This element signals the commitment of the public authorities to the integration of the rural banking system in formal, national financial markets. But under no circumstances should this validate past excesses, or even present policies whose unintended consequences may be providing unnecessary liquidity to the system and, therefore, disincentives for savings mobilization.

#### B2b. Open Ended Incentives

Tax breaks were overly generous and open ended. It is far from clear that they played a significant role during the take-off period, since many units were bound to lose money anyway during the initial years of operations. Tax exemptions could well have sent the wrong signals that rural banks would receive special treatment indefinitely. In addition, this incentive could have thwarted a more committed drive to increase the capital base.

Another incentive that is still open ended relates to equity matching. But the Land Bank, at present, is finding few takers. This suggests that a majority of the units no longer need this incentive.

#### B2c. Unit Banking

The Philippine rural banking system originally contemplated providing huge incentives to prospective bankers. One of the most appealing was unit banking, which stipulated the legal operation of just one bank per municipality. This was a distinguishing characteristic of the model,

which, in essence, conferred monopoly privileges to the lucky investors who had their licenses approved by the Central Bank. These bankers have no doubt earned substantial rents.

The rationale behind this policy was to speed up private investments. The policy can be assessed as a success in this regard, because the number of entrants increased year after year. Conversations with rural bankers revealed that this incentive proved crucially important in their decision to open up a bank and, consequently, in the rapid expansion of the system. It may be true, however, that the same results could have been obtained without the bait of captive markets. Furthermore, as evidence has surfaced that eliminating this provision has led to more dynamic growth in recent years, unit banking may well have held the rural banking system's expansion in check.

We surmise that unit banking was an inadequate incentive that other countries should dispense with. The principal reason is that it breeds inefficiencies and stagnation while nurturing the welfare of a handful of banks that spare no time and energy in protecting their vested interests *ad infinitum*. In time, they became mediocre bankers, because they were blinded by the limited opportunities that their municipalities offered and were thus incapable of assessing prospects that evolved elsewhere. It must also be stated that unit banking increased risk for banks by confining them to one municipality and customers who faced the same set of economic problems. It is telling that the more dynamic rural banks are aggressively engaged in branching out operations, because they have become convinced that diversification in lending operations leads to higher revenues.

#### B2d. Centralization of Key Administrative Functions

As noted before, licensing, training, and supervision were responsibilities assigned to the Central Bank. This arrangement made the Central Bank an active player in protecting a system that was largely of its own creation. In this sense, the Central Bank was a powerful ally of the rural banks. At the same time, however, the Central Bank's highly centralized decision-making powers and tight control over the rural banks may have been detrimental, if not to the particular banks that were licensed, to other financial entities willing to enter the market to partake of the large rents, but denied the authorization to do so. For example, it must be noted that the initial struggle to obtain licenses for opening cooperative rural banks was protracted and rife with nagging obstacles created by rural bankers and officials at the Central Bank.

The centralization of so many important functions in the Central Bank gave rise to serious conflicts of interest. Nowhere was this problem more dramatically apparent than in the supervision of the units during the frenzy years of Masagana 99. Supervisors at the Central Bank acted more as advocates of an ill-conceived policy than as officials committed to thorough and independent analyses of bank operations. Whether they enthusiastically embraced this policy or gave in reluctantly to political pressure, the result was an unmitigated disaster that left taxpayers holding the bill for defaults and costly bail out packages.

Another useful lesson relates to licensing procedures. When the system was launched, the granting of a license required only paid-up capital, proof of the owner's residency in the municipality where the bank would operate, and attendance at a basic rural banking training course offered by the Central Bank. But the historical evidence shows that many of the established banks, especially in the first 25 years, were not led by good bankers. In fact, many banks were managed by owners who, despite their attendance at training courses, should not have been qualified to run banks. A valuable lesson is that screening owners is not enough; screening managers is equally necessary. Licensing

should have focused on developing systematic procedures for approving senior managers and chief accountants on the one hand, and owners' financial capabilities on the other.

### C. Epilogue

Unlike other low-income countries, the Philippines set out to solve its rural microfinance problems by designing and implementing a system for rural financial intermediation. This approach is significant because its efforts concentrated on addressing the institutional vacuum problem, a major constraint to expanding markets that is characteristic of rural areas in many low-income countries. Put simply, this system's objective was to provide the foundations for the development of financial markets in a countryside that, in turn, made possible the emergence of privately owned rural and cooperative rural banks.

A central finding of this study is that the rural banking system is showing signs of increasing vitality. Barring a policy reversal or failure to respond to the challenges ahead, the system is poised for further, vigorous growth as the country moves more resolutely towards deeper financial reform. In fact, the present recovery is a by-product of the process of financial liberalization that has swept the country since the 1980s. At the same time, one cannot help but imagine how much more vibrant and dynamic the rural banking system would be today if such policies had prevailed from its inception. For the undeniable reality is that it survived in spite of unfriendly policies that were in effect for so long. It was the faulty execution of an essentially well-conceived strategy—not the strategy's underlying premises—that led the rural banking system astray. These principles were not modified and today underpin the vitality of the system. Most low-income countries stand to benefit immensely if they embrace a strategy founded on these principles.

In conclusion, the Philippine model offers two exceptional advantages that must be underscored. The first is that this model fosters the active engagement of rural bankers in the struggle to upgrade the quality of institutions in their localities. As mentioned in the first section, it is this problem that largely explains the poor development of rural financial markets. The second is that the Philippine model helps reduce market segmentation, a problem that underlines the marginalization of rural clienteles from formal financial markets. To wit, financial transactions between rural banks and large urban-based commercial banks are growing by leaps and bounds. Both rural banks and cooperative rural banks, for example, make deposits in commercial banks. These deposits, in turn, can be used as collateral to access lines of credit from the larger concerns. The consequence is that rural banks can leverage more resources. Commercial banks also offer stand-by and rediscount facilities to rural banks. The former, basically a bridge financing facility needed when the Central Bank or Land Bank rediscount lines are not delivered timely, are secured by owners' properties. In the second facility, a commercial bank acts as the Central Bank and its terms are usually more stringent.

These events are of major significance for a very important reason. Unlike the limited impact of financial liberalization on economies riddled by pronounced economic dualism, in the Philippines this problem is mitigated by the fact that financial policy reform finds in the rural banking system an outlet for bringing tangible benefits to a marginalized rural clientele. That such benefits could also materialize in the absence of the rural banking system is an illusion, because market reforms are fatally smothered in an institutional vacuum. An interesting scenario has evolved in the Philippines wherein the largest commercial banks are increasingly interested in exploiting spinoff business opportunities with rural banks, including opening special deposit facilities in cooperative rural banks, money transfer transactions, and operations of money remittances from Philippine expatriates that must find their way to outlets in the countryside. Furthermore, commercial banks have found it

advantageous to assist in introducing new banking technologies to rural bankers. Some of the largest concerns are reaping benefits from the sale of computer equipment and services to the most dynamic rural banks. In addition, commercial banks offer courses in the use and application of software that have had a great impact in automating procedures and, consequently, in reducing explicit transaction costs in several rural banks.

These trends suggest that markets are becoming more integrated in the Philippines. Therefore, this opens up the latent opportunity for commercial banks to adapt their operations to the lower segments of the rural market or, in other words, to launch successful downscaling programs. Significantly, the prior existence of a system of rural financial intermediation makes this feasible. It is not unreasonable to envisage a scenario in the near future in which commercial banks will have set up their own rural banks or bought up equity positions in some existing units. The latter option has clear advantages for rural banks, because it enables them to operate with the support of a “mother bank” that can make available larger volume of resources for lending and upgrading operations, factors that ultimately instill more confidence in customers. The result is a virtuous cycle whereby the beneficiaries are an expanding, formerly marginalized clientele as well as the nation at large.

ANNEX C  
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